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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 71-979

CITY OF CHICAGO, ILLINOIS, CITY AND COUNTY OF DENVER, COLORADO, THE AMERICAN PUBLIC GAS ASSOCIATION, *Petitioners*

v.

FEDERAL POWER COMMISSION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

RICHARD L. CURRY
Corporation Counsel
MATHIAS M. MATTERN
Assistant Corporation Counsel for Public Utilities.

BERNARD RANE
121 North LaSalle Street
Chicago, Illinois 60602
MAX P. ZALL
City Attorney
City and County of Denver
City and County Building
Denver, Colorado 80202

CHARLES F. WHEATLEY, JR.
JEROME C. MUYS
GRACE POWERS MONACO
2600 Virginia Avenue, N. W.
Washington, D. C. 20037

Attorneys for Petitioners

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FEDERAL POWER COMMISSION

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

The City of Chicago, Illinois, the City and County of Denver, Colorado, and the American Public Gas Association petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the District of Columbia Circuit entered in this case December 2, 1971.

OPINIONS BELOW

The opinion of the Court of Appeals for the District of Columbia Circuit issued December 2, 1971 is not yet officially reported. It is printed as Appendix A to

this petition. Opinion No. 568 and the accompanying order of the Federal Power Commission issued October 7, 1969 in the Pipeline Production Area Rate Proceeding (Phase I) is reported in 42 F.P.C. 738 (1969) and printed as Appendix B to this petition. Opinion No. 568-A and accompanying order of the Federal Power Commission issued December 5, 1969, denying rehearing, is reported in 42 F.P.C. 1089 (1969) and printed as Appendix C to this petition.

JURISDICTION

The judgment of the Court of Appeals, printed as Appendix A, was entered on December 2, 1971. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(i), and section 19(b) of the Natural Gas Act, 15 U.S.C. § 717r(b).

QUESTIONS PRESENTED

1. Whether the Federal Power Commission's abandonment of the judicially approved its individual cost-of-service regulation of rates for gas produced by natural gas companies and the application, without modification, of area rates developed for gas produced by independent producers to such pipeline production violates the consumer protection objectives of the Natural Gas Act.

2. Whether the Federal Power Commission's reliance on extra-record untested industry gas supply data as the basis for its policy decision to apply unmodified area rates to pipeline produced gas violates the consumer protection objectives of the Natural Gas Act and fundamental concepts of due process.

3. Whether the Court of Appeals erred in affirming the Commission Order below even though it recognized

that the Commission had not adequately explored the major premises necessary to protect consumers against excessive rates, when such affirmance was based on the erroneous conclusion that consumer interests will be able to litigate those disputed issues in future area rate proceedings when in fact the untested area rates are being charged by pipelines to consumers now.

STATUTE INVOLVED

The pertinent provisions of the Natural Gas Act, 52 Stat. 821-833, as amended, 15 U.S.C. 717-717w are set out in Appendix D to this petition.

STATEMENT

Proceedings Before the Federal Power Commission

This proceeding was initiated by Commission order of June 29, 1964 enlarging the pending Hugoton-Anadarko Area Rate Proceeding to add the issue as to whether natural gas produced by the nation's interstate pipeline companies and their affiliates which had theretofore been regulated on an individual cost-of-service basis should be regulated on an area basis.[1] The issue was severed from that proceeding on April 13, 1966 after the Commission determined that the Hugoton-Anadarko area was not typical of the nation as a whole.[2] The Commission also noted that "no evidence has been introduced upon which a determination could be made of the impact upon the consumers of the various pipelines of substituting an area rate for one based upon each company's individual cost . . ."[3] It further indicated that the issue was not

[1] 31 F.P.C. 1595 (1964).

[2] 35 F.P.C. 497 (1966).

[3] *Id.* at 498.

that of finding a suitable method for regulating pipeline and affiliated produced gas but rather the propriety of abandoning the established cost-of-service method.[4]

The proceeding was to be conducted in two phases. Phase I, which is the subject of this petition, concerns the pricing of gas produced from leases acquired by pipelines subsequent to the date of the Commission's decision and taken into the pipelines' own system—"new" gas. Phase II, which has not yet begun, will determine the pricing method to be used for gas taken into the system from leases acquired prior to that date.

Hearings in the severed proceedings in Phase I, styled as the *Pipeline Production Area Rate Proceedings,* Docket No. RP66-24, were commenced on September 27, 1967 and concluded on April 2, 1968. The hearing record before Presiding Examiner Allen C. Lande involved fifty volumes of transcript of 5670 pages, and 85 exhibits and items by reference.

The presiding examiner issued his decision on March 3, 1969.[5] Based on a careful review of the record evidence he rejected area rate treatment for new gas produced by pipelines or their affiliates and adhered to a slightly modified individual company cost-of-service method. His recommended modifications were (a) that the pipeline producer and the consumers split the tax benefits attributable to the deductions for percentage depletion and for intangible well drilling costs, and (b) that ten percent of the total volumes produced in one year by an affiliate might be priced at area rates.

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[4] *Id.*

[5] 42 F.P.C. 755 (1969).

The Commission in Opinion 568[6] held completely contrary to the Examiner on all points, although it did not expressly overturn his findings. It concluded that (1) unmodified area rates developed for independent producers should govern the cost attributable to gas produced by pipelines or their affiliates; (2) the same overall rate of return permitted the independent producers should be permitted to the pipelines and their affiliates; and (3) pipelines should be permitted to retain the benefit of tax credits by not having them considered in fixing the tax allowance on their transmission operations.

Applications for Rehearing were denied on December 5, 1969 in Opinions No. 568-A.[7]

Proceedings Before the Court Below

Petitioners sought review of the Commission order in the Court of Appeals for the District of Columbia Circuit. By order of December 2, 1971, the court issued its opinion and judgment affirming, with qualifications, the Commission's order.[8] After a lengthy discourse on the nature of the proceedings below, in which it concluded that they constituted rulemaking as opposed to adjudication, the court considered and rejected four principal arguments advanced by petitioners. Its treatment of those issues appears to have been largely premised on its determination that the proceedings were not adjudicatory, inasmuch as the court repeatedly asserted that the issues raised by peti-

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[6] Appendix B.

[7] Appendix C.

[8] Appendix A.

tioners could later be raised in the context of "actual area rate cases."[9]

The court expressly qualified its affirmance of the Commission's decision approving the use of area rates for pipeline production in two critical areas,—(a) treatment of the rate of return on production permitted pipeline producers, and (b) treatment of federal income tax benefits. With respect to the rate of return on production investments, the court concluded that:[10]

> the Commission's decision to allow pipeline producers the same rate of return on new production as it allows independent producers can be a starting point only and . . . the propriety of actually allowing the two groups a single rate of return will have to be determined on the basis of the facts developed in an actual area rate case.

With respect to petitioners' argument that the Commission's treatment of federal income tax benefits for pipeline producers violated the "actual taxes paid" principle because the use of area rates will eliminate savings to consumers stemming from tax savings "spilled over" from pipeline production activity to transmission activity, it stated that "the record does not reflect whether the Commission has fully explored the problem."[11] Acknowledging that "ordinarily, under such circumstances, we would remand the case to the Commission so that it could supply this omission", the court chose not to remand, but to leave that

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[9] See pp. 15, 21, 27-28, *infra*.

[10] Appendix A, p. 45a.

[11] Appendix A, p. 50a.

evaluation to be "undertaken in the context of an actual area rate proceeding." [12]

The Court's opinion ended as follows:[13]

> With that caveat [as to federal income tax treatment] and our comments concerning the rate of return in mind, we affirm the order of the Federal Power Commission here under review.

The judgment entered by the court was not qualified in any way.

REASONS FOR GRANTING THE WRIT

The questions presented by the Federal Power Commission's order of October 7, 1969[14] and the affirmance of that order by the court below are of substantial importance to the proper administration of the Commission's regulatory responsibilities under the Natural Gas Act.

The court's decision below erroneously affirms a major policy decision by the Commission to jettison 30 years of judicially approved regulation of the production of natural gas by natural gas pipelines on an individual company cost-of-service basis and to substitute, without any modification because of different cost considerations, the area rates set for production by independent producers under the methodology sanctioned by this Court in the *Permian Basin Area Rate Cases*[15] for limited application to independent producers.

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[12] Appendix A, p. 50a-51a.

[13] Appendix A, p. 51a.

[14] Appendix B.

[15] Permian Basin Area Rate Cases, 390 U.S. 747 (1968).

The Commission justifies its departure from its long standing, judicially approved regulatory treatment of pipeline production on the basis of an assumed natural gas shortage, postulated primarily on extra-record untested industry gas supply data. This practice, which is being challenged by consumer groups in two major area rate cases now under review in three different circuits,[16] casts a cloud on the integrity of the Commission's regulatory practices and subverts the consumer protection objectives of the Natural Gas Act.

Finally, the Court's mistaken concepts as to the nature of the Commission proceeding under review and its relationship to other Commission rate making proceedings raises novel and serious questions of administrative law and appears to have deprived petitioners and other consumers of property without due process of law. Despite the court's ruling below that the Commission must consider the different higher rate of return and tax spillover benefits accruing to the pipelines under area rate treatment, the court's reference of these key issues to future area rate cases erroneously deprives consumers *now* of large sums without such safeguards.

We discuss each issue seriatim.

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[16] Civ. No. 71-1724 (D.C. Circuit, recently transferred to 5th Cir.) (Southern Louisiana Area Rate Case); Civ. No. 71-1036 (9th Cir.) (Hugoton-Anadarko Area Rate Case); Civ. No. 71-1812 (D.C. Cir.) (Rocky Mt. Area Rate Case).

1. The Commission decision to discard its long standing, cost based regulation of individual pipeline producers and to substitute inappropriate, unmodified area rates developed for independent producers violates the salutory standards for such action previously laid down in City of Detroit v. FPC and cannot be sustained under this Court's decision in the Permian Basin Area Rate cases.

Since the earliest days of the Natural Gas Act, this Court has approved Commission cost-of-service regulation of natural gas production by natural gas pipeline companies against challenges by such companies attempting to have pipeline gas production priced at substantially higher values.[17] After a change of membership in the Commission in the early 1950's, another attempt was made to have the Commission abandon the cost-of-service method of regulation for pipeline produced gas. In *Panhandle Eastern Pipe Line Co.*, a bare majority of the Commission decided to "re-examine" the issue and concluded that a pipeline should "receive for the gas it produces a price reflecting the weighted average arm's length payments for identical natural gas in the fields . . . where it is produced . . ."[18] The Commission was reversed in *City of Detroit* v. *FPC*.[19] While the court did not consider the Commission bound to the traditional rate base method of regulation for pipeline produced gas, it held that the contentions posed by the Commission for abandonment of that system did not satisfy the primary aim of the

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[17] See, e.g., *FPC* v. *Hope Natural Gas Company*, 320 U.S. 591 (1944); *Colorado Interstate Gas Company* v. *FPC*, 324 U.S. 581 (1945); *Panhandle Eastern Pipe Line Company* v. *FPC*, 324 U.S. 635 (1945).

[18] 13 F.P.C. 53, 76 (1954).

[19] 230 F.2d 810 (D.C. Cir. 1955), *cert. denied*, 352 U.S. 829 (1956).

Natural Gas Act" 'to protect consumers against exploitation at the hands of natural gas companies.'" The Commission contention that the traditional rate-base system did not sufficiently encourage the discovery and development of gas was rejected on the following grounds:[20]

> If the Commission contemplates increasing rates for the purpose of encouraging exploration and development, or the ownership by pipeline companies of their own producing facilities, it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose. Further than this we think the Commission cannot go without additional authority from Congress.
>
> The amount allowed Panhandle for the encouragement referred to is not shown to meet this test by any evidence and findings. Of course the rate increase attributable to producing properties might have a tendency to encourage their ownership, and perhaps also the development of new sources of production, as an even greater increase also might do. But the question is whether a lesser amount would suffice. The amount here allowed is not brought into relationship by the evidence and findings with the purposes for which it is granted except that it affords a larger revenue to Panhandle than otherwise it would have. This is not an adequate basis for bringing the resulting rates within the "just and reasonable" standards of the Act. The mere fact that the field price method is used does not vindicate the rates. Its use can be justified only in terms of a demonstrated public interest. In this case an allowance for the desired purposes, assuming they are valid, could be included without resort to the field price system. When the latter method is used the evidence and findings must show that the increase in rates thus caused

[20] 230 F.2d at 817-818.

> is no more than is reasonably necessary for the purposes advance for any increase. Since there is nothing in these proceedings from which such a conclusion could be drawn, they are fatally defective. We simply say that if the Commission is now to abandon the treatment historically accorded pipeline-produced gas in rate making on the ground that the ultimate public interest will be better served thereby, the Commission should justify it on the record.

The court strongly emphasized that a showing of the the comparison of the impact on consumers of switching to a new system was vitally important:

> Furthermore, it is seen that when we refer to an "increase" we mean an increase in the rates above those which would result from use of the conventional rate-base method. For, though we hold that method not to be the only one available under the statute, it is essential in such a case as this that it be used as a basis of comparison. It has been . . . repeatedly approved by the courts, as a means of arriving at lawful—"just and reasonable"—rates under the Act. Unless it is continued to be used at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms "just and reasonable" to some recognizable meaning.[21]

On remand the Commission held that Panhandle's production properties must be regulated on a cost basis and its order was sustained on appeal.[22]

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[21] 230 F. 2d at 818-819.

[22] Panhandle Eastern Pipe Line Company, 25 F.P.C. 784, 785 (1961); Panhandle Eastern Pipe Line Company, 25 F.P.C. 787 (1961); Panhandle Eastern Pipe Line Co. v. FPC, 305 F. 2d 763 (D.C. Cir. 1962), *cert. denied*, 372 U.S. 916 (1963).

The current proceedings are simply a replay of the earlier 1954 Panhandle effort, but with a larger cast of characters, *i.e.*, all of the pipeline producers. The Examiner expressly found that the pipeline producers' evidence was no more persuasive now than it was 15 years ago and held that "the parties asking higher rates have failed to supply specific evidence sufficient to meet the standards of the *City of Detroit* case . . . "that the rate increase is in fact needed and is no more than is needed, for the purpose. . . ."[23] The Commission, in rejecting the recommendations of the Examiner and the Staff, did not directly dispute the Examiner's findings based on the record, but asserted with respect to the *City of Detroit* criteria that:

> . . . clearly the 'anchor' the court there felt should be the 'point of departure' in moving to a pricing system other than the conventional rate-base method . . . lies in the approved just and reasonable area rates for independent producers.[24]

The court below, while not disputing the continuing validity of the *City of Detroit* principles, held that the area rates which the Commission proposes to extend to pipeline production constitute a sufficient "cost anchor" within the rule of that case, inasmuch as "area rates are essentially rates based on composite cost of service for all producers in a given geographic area" so that "producer costs thus remain at the heart of the regulatory system."[25] The conclusion by both the Commission and the court that the *City of Detroit* criteria for departure from the long standing method of

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[23] 42 F.P.C. 755, 798.

[24] Appendix B, p. 62a.

[25] Appendix A, p. 38a.

pricing pipeline-produced gas is met because area rates have been adjudicated just and reasonable with respect to independent producers is contrary to distinctions between independent producers and pipeline companies previously recognized by this Court.

In the *Permian Basin Area Rate Cases*,[26] this Court stressed that factors of administrative convenience required experimentation with a different regulatory technique from cost-of-service for independent producers.[27] The Court carefully delineated the scope of its opinion upholding the validity of the Commission's area rate ruling in *Permian* as applicable only to the regulation of "independent producers", defined as those "that do not engage in the interstate transmission of gas from producing field to consumer markets and [are] not affiliated with any interstate natural-gas pipeline company.[28] In so doing, the Court carefully distinguished interstate pipelines having production operations, which had long been classified as public utilities subject to individual cost-of-service regulation.[29]

Furthermore, the record below shows that the pipeline cost variances are quite different from those of the independent producers. Consequently, the Commission's application of unmodified area rates to the pipeline producers, when there is no record basis of substantial cost comparibility of the two groups, is contrary to an established line of cases holding that administrative agencies must calculate rates for a regulated

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[26] 390 U.S. 747 (1968).

[27] 390 U.S. at 757-58.

[28] 390 U.S. at 755-56.

[29] *Id.*

class on the basis of evidence which is representative and ample in quantity to measure with appropriate precision the financial and other requirements of the pertinent parties.[30]

Secondly, the court below completely failed to address the other mandate of *City of Detroit,* namely that if, as here, "the Commission contemplates increasing rates for the purpose of encouraging exploration and development . . . it must see to it that the increase is in fact needed, and is no more than is needed, for the purpose."[31] With respect to that missing link, the court erroneously assumes that the Commission will be able to direct itself to that critical issue in future area rate proceedings:[32]

> [I]t must be remembered that the sole issue here involves the proper *method* to be followed in placing a value for rate-making purposes on much of the new gas to be produced by pipeline companies. The actual value permissible for such gas will be determined by future rate proceedings for individual producing areas. In the context of these future proceedings, petitioner and others will have an opportunity to explore in some detail the extent of the anticipated gas shortage as well as the precise amount of incentive needed to combat it.

This assertion evidences an erroneous misconception of the status of the various area rate proceedings and the

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[30] See, *e.g., Tagg Brothers* v. *United States,* 280 U.S. 420 (1930); *Acker* v. *United States,* 298 U.S. 426 (1936); *United States* v. *Corrick,* 298 U.S. 435 (1936).

[31] *City of Detroit* v. *FPC,* 230 F. 2d 810, 818 (D.C. Cir. 1955), *cert. denied,* 352 U.S. 829 (1956).

[32] Appendix A, p. 32a.

intended relationship of the Commission's order in this case to those proceedings.

The heart of the Commission's decision below was stated by the Commission as follows:[33]

> The issue in Phase I of this proceeding is whether we should *now* apply such area rates, or some variant or modification thereof, in future pipeline rate cases to value the gas produced from pipeline owned (or pipeline affiliate owned) leases acquired after the date of this decision and taken into the pipeline's own system.
>
> For the reasons set forth, we conclude that, subject to a showing in such future pipeline rate cases of special circumstances warranting a different result, the just and reasonable area rate ceilings governing sales by independent producers to the various pipelines (or, where area just and reasonable rates have not yet been set, the appropriate in-line or guidelines price applicable to sales by independent producers) should be utilized for such purposes.

It is indisputable that under the Commission's decision below pipeline companies in fact are now charging their consumers for gas produced from pipeline owned leases at the values *previously* established for independent producers in separate area rate proceedings. Under the Commission's decision in the *Southern Louisiana Area Rate Case* of July 15, 1971, the pipelines are entitled to and are tracking through all area rate increases without filing a pipeline rate case.

The court, however, apparently mistakenly assumes that the Commission has not yet estabilshed the area rates which the Commission's order would permit the

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[33] Appendix B, pp. 59a-60a (emphasis added).

pipeline producers to utilize. However, rates have in fact already been determined for independent producer production in the major gas producing regions of the nation—Permian Basin, Southern Louisiana, Texas Gulf, Rocky Mountain, and Hugoton-Anadarko regions.[34] The initial Permian Basin area rates have already been approved by this court and the other Commission area rate determinations are in various stages of judicial review.[35]

In light of its treatment of the gas supply, rate of return, and federal income tax issues, discussed *infra*, the court obviously erroneously assumed that the Commission did not intend to apply area rates to pipeline production until it had conducted further area rate proceedings in which it would pay special attention to the disputed issues raised by petitioners in this proceeding. That is clearly not the Commission's intention, and is obviously why the Commission conducted the proceeding below in an adjudicatory format. The Commission in fact is now applying existing area rates, designed for independent producers, to pipeline production without further action on those existing area rates. The area rates being applied do not contain any adjustments for the rate of return and tax spillover benefits to pipelines deemed essential by the court below to protect consumers. Thus, despite the court's char-

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[34] Permian Basin Area Rate Cases, 390 U.S. 747 (1968); Southern Louisiana Area Rate Cases, 40 F.P.C. 530 (1968), aff'd, 428 F. 2d 407 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970), reopened Dec. 24, 1970, 36 Fed. Reg. 69; decision on reopening FPC Opin. Nos. 598 (July 16, 1971) and 598-A (Sept. 9, 1971); Hugoton-Anadarko Area Rate Proceeding, 44 F.P.C. 761 (1970); Texas Gulf Coast Area Rate Proceeding, F.P.C. Opinion Nos. 595 (May 6, 1971) and 595-A (Oct. 18, 1971); Rocky Mountain Area Rate Proceeding, F.P.C. Op. Nos. 435 (July 15, 1971) and 435-A (Sept. 7, 1971).

[35] Notes 15, 16 and 34 *supra*.

acterization of the instant proceedings as "rulemaking," they were intended to and in fact do constitute a present adjudication of the rights of pipeline companies to utilize existing area rates in their individual pipeline rate cases. There is no tomorrow for petitioners and other consumer groups, the lower court's assumptions to the contrary notwithstanding.

It is particularly important that consumer groups have their day in court on this issue, inasmuch as it is clear that the extension of area rates to pipelines and their affiliates would have a severe dampening effect on the desire of pipeline companies to bargain for lower cost supplies for the benefit of consumers. Pipelines having their own or affiliated production would obviously be discouraged from resisting high area rates paid to producers, all to the detriment of ultimate consumers. The extension of area rates, designed for independent producers, to their supposed competitors, the pipeline companies, would stifle rather than encourage competition within the regulatory frame-work, thereby aggravating the "deficiencies of the market mechanism" already pointed out by this court in its *Permian Basin Area Rate Cases* decision:[36]

> The field price of natural gas produced in the Permian Basin has in recent years steadily and significantly increased. These increases are in part the products of a relatively inelastic supply and steeply rising demand; but they are also symptomatic of the deficiencies of the market mechanism in the Permian Basin. Producers' contracts have in the past characteristically included indefinite escalation clauses. These clauses, in combination with the price leadership of a few large

[36] Permian Basin Area Rate Cases, 390 U.S. 747, 793-94 (1968) (emphasis added).

producers, *and with the inability or unwillingness of interstate pipelines to bargain vigorously for reduced prices,*[63] have created circumstances in which price increases unconnected with changes in cost may readily be obtained.

[63] The Commission stated that "the entire history of pipeline purchasing activity, since the end of the El Paso monopoly in the Permian Basin, has been characterized by the overriding needs of the pipelines to contract for the large blocks of uncommitted reserves essential to maintain their competitive position in developing markets . . . and their inability to accomplish this objective except at ever increasing prices." 34 FPC, at 182. *It is noteworthy that, despite the obvious importance of these proceedings, the pipeline companies did not take an active part here, in the Court of Appeals or before the Commission.*

2. The Commission's decision to supplant its long-standing cost of service approach for pipeline production operations with unmodified area rates is grounded on an assumed national gas shortage purportedly demonstrated by extra-record, untested industry gas supply data, in violation of the consumer protection objective of and the Commission's responsibilities under the Natural Gas Act, as well as fundamental principles of due process.

The catalyst for the Commission's departure from its traditional individual company cost-of-service approach to regulation of the production operations of pipeline companies is what the Commission refers to at the outset of its opinion as "an apparent gas shortage."[37] The Commission buttresses its assertion of "indications of a shortage of gas and a threat of a greater shortage in the future" by reference to statistics from an April 7, 1969 report of the American Gas Association Committee on Annual Gas Reserves, which it acknowledges "are not in the record."[38] The sta-

[37] Appendix B, p. 59a.

[38] Appendix B, pp. 62a-63a.

tistics reported by the industry trade association are internally inconsistent and reflect unexplained manipulations of data. Moreover, the unexplained nosedive in annual reserve additions which the 1969 and subsequent reports by the AGA reflect occurred only after this Court's *Permian* decision in 1968[39] and the Commission's first *Southern Louisiana* area rate decision in September, 1968,[40] had rejected producer claims for higher rates based on asserted declining reserve to production (R/P) ratios and had stressed that *annual* reserves additions did not appear to be unsatisfactorily low. Neither the Commission nor any party had the opportunity to review the data used in the AGA figures, much less to test it by cross-examination of those who prepared it. However, the Commission found those extra-record statistics supported by record evidence of a general downward trend of the ratio of reserves to production from 1955 to 1968,[41] even though this Court had indicated in the *Permian Basin* decision the dubious significance of the reserves to production ratios.[42]

The Court below concluded that, whether the Commission action was considered adjudication or rulemaking, "the Commission's use of extra record statistical data did not in any way unfairly deprive petitioner of any substantial right."[43] We disagree. The critical issue is not, as the court suggests, whether the

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[39] 390 U.S. at 816-817.

[40] Southern Louisiana Area Rate Proceeding, 40 F.P.C. 530, 550-52 (1968).

[41] Appendix B, p. 63a.

[42] Permian Basin Area Rate Cases, 390 U.S. at 816-817.

[43] Appendix A, p. 28a.

parties should have been on notice somehow that gas supply is implicitly an issue in every Commission rate proceeding, an assumption we dispute. Nor is the issue solely, as the court assumes, the proper "interpretation" of the AGA statistical data. The pivotal issues are the validity of the AGA data and the propriety of the Commission utilizing untested gas supply data provided by the very economic interests it is supposed to be regulating as the foundation for a major departure from its traditional regulatory practices.

The basic rationale for the court's rejection of petitioners' arguments on this issue is its erroneous assumption that the validity of the data and the legitimacy of the gas shortage issue may be explored in future proceedings.

> The actual value permissible for such gas will be determined by future rate proceedings for individual producing areas. In the context of these future proceedings, petitioner and others will have an opportunity to explore in some detail the extent of the anticipated gas shortage as well as the precise amount of incentive needed to combat it. The order currently before us represents only the Commission's determination that, to the extent a gas shortage is threatened, increased exploration and production will be needed from both independent producers and pipeline companies alike, and that the area rate concept is the most efficient method of stimulating such increases and at the same time protecting consumers from bearing the full cost of some unsuccessful exploratory efforts. *Thus, the precise magnitude of the possible gas shortage was not fully explored,* was not necessary to determine before the Commission reached its decision *and both can and should be examined by parties to future area rate proceedings.* For the above reasons, we conclude that petitioner's claim that

the Commission erred in referring to data not contained in the record is without merit.[44]

The alleged future opportunity to litigate the gas shortage issue is illusory, not only because the record has been closed in most area rate cases but, more importantly, because in the one area rate case where the validity of the AGA reserve data was in issue, the second round *Southern Louisiana proceedings,*[45] the accuracy of the AGA data was not thoroughly tested.

A few months after the Commission's order on rehearing in these proceedings, the Fifth Circuit on March 19, 1970 handed down its decision in the Southern Louisiana area rate cases.[46] In addressing the gas supply problem, which it termed "the most important and the most difficult question in this case," [47] it made it clear that further definitive action by the Commission was necessary on this vital issue. The Court's concern with the gas shortage possibility was tempered with recognition of "the frequency with which this argument has been effectively categorized as a 'cry of wolf' . . ." [48] It criticized "the Commission's failure to make thorough findings on the matter," [49] but explained that "this Court cannot itself evaluate the supply situation or determine what action is needed",

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[44] Appendix A, pp. 32a-33a (emphasis added).

[45] Southern Louisiana Area Rate Cases, FPC Opin. No. 598 (July 16, 1971) and 598-A (Sept. 9, 1971).

[46] Southern Louisiana Area Rate Cases, 428 F. 2d 407 (5th Cir. 1970), *cert. denied,* 400 U.S. 950 (1970).

[47] 428 F. 2d at 439.

[48] 428 F. 2d at 437-38.

[49] 428 F. 2d at 438-440.

since it did "not know whether the information that has reached us is correct or not." [50] The Commission's response to the Fifth Circuit's criticism was to reopen the *Southern Louisiana Area Rate Proceedings* to examine, among other issues, the gas supply issue.[51]

In the "second round" Southern Louisiana Area Rate proceedings,[52] the validity of the AGA reserve statistics has become a controversial issue. Two principal criticisms have been levelled by consumer groups: (1) the lack of opportunity afforded the parties to test the validity of the AGA data because of claims of confidentiality raised by the AGA; (2) the questionable accuracy of the data in light of a significant discrepancy between the AGA estimates and other estimates contained in FPC Form 15 reports submitted to the Commission by interstate pipelines. The latter discrepancy and the Commission's failure to attempt to reconcile the conflicting data were highlighted in a series of articles by columnist Jack Anderson and resulted in a Congressional hearing exploring the propriety of Commission reliance on such industry data.[53] The Subcommittee on Special Small Business Problems of the House Select Committee on Small Business strongly condemned that Commission practice.[54] The Commission has recently launched a survey purportedly

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[50] 428 F. 2d at 440.

[51] 36 Fed Reg. 69 (1970).

[52] Note 45 *supra*.

[53] Hearings on Concentration by Competing Raw Fuel Industries in the Energy Market and its Impact on Small Business before the Subcommittee on Special Small Business Problems of the House Select Committee on Small Business, 92 Cong., 1st Sess. 315-18. 329-33, 344-420 (1971).

[54] H.R. Rep. No. 92-719, 92d Cong., 1st Sess. 13-15, 20 (1971).

designed to elicit more objective gas reserve data,[55] but consumer groups have objected to the study limitations and to the industry domination of the advisory groups which are to carry out the study.[56] It seems clear that the continued Commission utilization of untested, industry supplied data in carrying out its regulation of the natural gas industry is wholly subversive of the consumer protection objectives of the Natural Gas Act. Further, to preclude meaningful cross examination of data on which the Commission places such great reliance violates the most minimal elements of due process.

It is not enough, as the court below suggests, that there are bits and pieces of the record in this case that relate peripherally to the question of gas supply. The fundamental issue, considering the paramount consumer interest which is at the heart of the Natural Gas Act, is whether the Commission has carried out its obligation to develop an adequate record on the gas supply issue which is fundamental to the Commission's decision. Where the broad interest of the public is involved, as here, the Commission has an affirmative duty to develop a comprehensive record. The Second Circuit has stated it more strongly:[57]

> If the Commission is properly to discharge its duty in this regard, the record on which it bases its

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[55] FPC orders of December 21, 1971. "Directing Study and Analysis of Natural Gas Reserves and Prescribing Procedures for the Natural Gas Survey" and "Establishing Technical Advisory and Coordinating Committee Task Forces and Redesignating Membership."

[56] Petition for Rehearing by American Public Gas Association, American Public Power Association, and the Consumer Federation of America of FPC orders of December 21, 1971, n. 55 *supra*.

[57] Scenic Hudson Pres. Conf. v. FPC, 354 F. 2d 608, 612, 620 (2d Cir. 1965), *cert. denied*, 384 U.S. 941 (1966).

> determination must be complete. The petitioners and the public at large have a right to demand this completeness . . .
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> * * *
>
> In this case, as in many others, the Commission has claimed to be the representative of the public interest. This role does not permit it to act as an umpire blandly calling balls and strikes for adversaries appearing before it, the right of the public must receive active and affirmative protection at the hands of the Commission.

In the case below, the public did not even get a chance to come to bat, since the pivotal gas shortage issue was never litigated.

Finally, it should be obvious that this critical evidentiary void cannot be filled by utilization of the American Gas Association statistics in the manner employed by the Commission, namely, to attempt to bootstrap an apparent record on the gas supply situation through the wholly improper use of the doctrine of official notice.[58] To permit the Commission to do so would violate fundamental concepts of due process and make a mockery of the administrative process.

3. The court's affirmance of the Commission was based on the mistaken assumption that the Commission did not intend to permit pipeline producers to use existing area rates and that the issues raised by petitioners will be subject to litigation in future area rate proceedings.

With respect to each issue presented to the court below for review, except whether the proceeding was rule-making or an adjudication, the court appears to justify its affirmance of area rate pricing methodol-

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[58] Ohio Bell Telephone Company v. Public Utility Commission, 201 U.S. 292, 301-304 (1937).

ogy for pipeline production on the mistaken assumption that consumer interests would be able to litigate the issues the court recognized as vital to consumers in future area rate proceedings. The court mistakenly assumed, contrary to the obvious purport of the Commission action which it affirmed, that area rates already established would not be automatically applied to pipeline production and that rates to be allowed pipelines would be developed in future individual area rate proceedings. We have previously discussed this aspect of the Court's treatment of the gas supply and *City of Detroit* issues, pp. 14-17, 20-21 *supra*. However, the most dramatic illustration of this underlying misconception is found in connection with the court's treatment of rate of return and federal income tax benefits for pipeline producers.

Rate of return on production investment. In dealing with the impact on the pipeline producers vis a vis independent producers from applying the same rate of return on production properties to pipelines as has been permitted independent producers, specifically, whether application of the same rate of return would result in exhorbitant profits to the pipeline producers (20-40 percent on equity), it is evident that the court's assumption that all specific determinations concerning pipeline producer rates would be made in future individual area rate proceedings motivated it to give "qualified" acceptance to the Commission's application of the rate of return granted independent producers as a *starting point* in regulation of the pipeline producers. It seems clear that if the court had been aware that area rates already determined would be automatically applied to pipeline production, it would at least have conditioned its affirmance on a re-opening of the terminated area rate pro-

ceedings for inclusion and evaluation of pipeline data on the cost comparability assumption which is the keystone of identical rate of return treatment.[59] Indeed, it should have remanded the case for that purpose.

Specifically, the court's affirmance in principle of the application of area rates to pipeline production was based on qualified acceptance of the Commission's basic premise or "prediction" that both groups would have similar costs in the future. The court recognized that if this "prediction" turned out to be unfounded the costs incurred by independent producers could *not* be averaged with those incurred by pipelines to derive a just and reasonable rate for both. Consequently, the court held that:[60]

> In an actual area rate proceeding, the Commission may start from the premise that the same rate of return should be applied to the production investment of both independent producers and pipeline companies in the area under consideration. *However, our decision . . . can be a starting point only and . . . the propriety of actually allowing the two groups a single rate of return will have to be deter-*

[59] The court also erroneously assumes that the composite area rate is an average reflecting the experience of both pipelines and independent producers. This assumption is not accurate with respect to the area rate proceedings which have already been terminated nor is it an accurate description of the record in this proceeding. For example, Examiner Lande found and the Commission did not dispute that the Staff cost data in the record of the *Permian* proceedings, upon which the Commission based its unit cost conclusions, did not even include representative data on pipeline production operating costs. (42 F.P.C. 755, 1771). Similarly, the Pipeline Production Questionnaire data collected for this proceeding would not permit a cost determination for the pipeline respondents herein since operating costs were not included. (42 F.P.C. at 769-70).

[60] Appendix A, p. 45a.

mined on the basis of the facts developed in an actual area rate case. (emphasis added)

Federal Income tax treatment. With respect to the "actual taxes paid" issue, the court recognized that because pipeline producers (unlike independent producers) have jurisdictional business activities (their transmission systems) in which "spilled over" tax benefits can be utilized, that

> [T]here would thus be some force to an argument that the Commission cannot simply stop when it has determined that pipelines, on the average, will pay no taxes on their production activity but must then go on to determine whether they will have a net tax loss and should reflect that loss by including a negative tax element in the area rate.[61]

The court noted that it could not ascertain from this record whether the Commission had explored the above noted problem and observed that on such a deficient recorn it would usually remand. However, it concluded that the particuar circumstances of this proceeding did not warrant remand because evaluation of this problem "would be most appropriately undertaken in the context of an actual area rate proceeding in which the Commission gathers before it all relevant financial data concerning producers in the area."[62]

With respect to the area rate proceedings already terminated; which cover all the major producing areas, resolution of these issues would not be undertaken until the next round of area rate increases, which, if the experience of the Permian Basin is typical would not be for many years into the future. In the interim

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[61] Appendix A, p. 50a.

[62] *Ibid.*

consumers may be paying an excessive return to the pipelines because of their utilization of existing area rates which have not been modified to reflect the considerations which the court enumerated. Further, should any future area rate determination establish that area rates for independent producers are inappropriate for pipeline producers, consumers will have no way to recoup excessive charges antedating the commencement of second round proceedings. They will thus have effectively been deprived of their property without due process.

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition for a writ of certiorari should be granted.

Respectfully submitted.

RICHARD L. CURRY
Corporation Counsel

MATHIAS M. MATTERN
Assistant Corporation Counsel
for Public Utilities

BERNARD RANE
121 North LaSalle Street
Chicago, Illinois 60602

MAX P. ZALL
City Attorney
City and County of Denver
City and County Building
Denver, Colorado 80202

CHARLES F. WHEATLEY, JR.
JEROME C. MUYS
GRACE POWERS MONACO
2600 Virginia Avenue, N. W.
Washington, D. C. 20037

Attorneys for Petitioners

January 31, 1974

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 23,740

CITY OF CHICAGO, ILLINOIS, ET AL., PETITIONERS

v.

FEDERAL POWER COMMISSION, RESPONDENT

PIPELINE PRODUCTION GROUP,
MID LOUISIANA GAS COMPANY,
PENNZOIL PRODUCING COMPANY,
TENNESSEE GAS PIPELINE COMPANY,
CONSOLIDATED GAS PIPELINE CORPORATION, ET AL.,
TENNECO OIL COMPANY,
INTERVENORS

Petition for Review of an Order of the Federal Power Commission

Decided December 2, 1971

Before MACKINNON, ROBB and WILKEY, *Circuit Judges*.

MACKINNON, *Circuit Judge*: This case is before us on a petition under Section 19(b) of the Natural Gas Act[1] to review a decision issued by the Federal Power Commission on October 7, 1969[2] directing that gas produced by natural

[1] Natural Gas Act of 1938, ch. 556 § 19(b), 52 Stat. 831, 15 U.S.C. § 717r(b) (1970).

[2] Pipeline Production Area Rate Proceeding (Phase I), 42 F.P.C. 738, *reh. denied*, 42 F.P.C. 1089 (1969).

gas pipeline companies from leases acquired after October 7, 1969 and which is used on-system[3] should be valued for rate-making purposes at the area rate applicable to independent producers.[4] For reasons to be discussed below, we affirm the Commission's decision with two reservations.

I.

Background

In order to place the instant controversy in its proper perspective, a brief discussion of the FPC's recent regulatory effort with respect to natural gas is necessary. Three sections of the Natural Gas Act give the commission its primary tools for regulating natural gas rates. Under Section 7(c),[5] a producer of natural gas must obtain from the Commission a certificate of convenience and necessity before it can make sales in interstate commerce. In the so-called *CATCO* case,[6] the Supreme Court held that before such certificates are issued, the Commission must insure that the rates to be charged by the producer are "in line" with those

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[3] "On-system" gas, as the term is here used, means that gas which is produced by a pipeline company or its affiliate and transported by the pipeline company through its own pipelines to the purchaser. "Off-system" gas, is gas produced by pipeline companies and sold to other pipeline companies. No questions involving the price of off-system gas are presented by the instant petition for review.

[4] Independent producers are those producers of natural gas which do not "engage in the interstate transmission of gas from the producing fields to the consumer markets and [are] not affiliated with any interstate natural-gas pipeline company." Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672, 675 (1954).

[5] 15 U.S.C. § 717f(c) (1970).

[6] Atlantic Ref. Co. v. Public Service Comm'n, 360 U.S. 378 (1959).

being charged for gas sold by other producers and extracted from the same general area. The Commission thus has some measure of responsibility for the initial prices a producer set for his gas. When price increases are effected, the second of the Commission's three major tools comes into play. Under Section 4(e)[7] of the Act, the Commission has the power to suspend any proposed rate increases for a maximum of five months while it conducts an investigation to determine whether the proposed rates will be "just and reasonable". If five months elapse before the investigation is completed, the new rate goes into effect, but the producer must post a bond conditioned upon refunds being made in case the increase is held unlawful and a refund is ordered by the Commission. Finally, under Section 5(a),[8] the Commission may at any time commence an investigation into whether a given rate is "just and reasonable." If it finds that the rate does not meet this standard, it may fix an appropriate rate for the future, but Section 5(a) does not empower the Commission to order refunds.

The Natural Gas Act became law in 1938 and was initially applied by the Commission only to pipeline companies, *i.e.*, those companies which were engaged in the interstate transmission of natural gas. While the methods used by the Commission to determine which rates were just and reasonable underwent some changes over the years, the concept that rates should be based on each individual company's "cost of service" remained at the heart of the regulatory scheme.

> [I]n essence [cost of service] includes, in addition to operating costs, depreciation, etc., the "return" to the company which the Commission calculates by providing a fair rate of return on a rate base equal to the amount

[7] 15 U.S.C. § 717c(e) (1970).

[8] 15 U.S.C. § 717d(a) (1970).

prudently invested in utility property, and the "expense" of federal income tax payable on the allowed return.[9]

In 1954, however, in the case of *Phillips Petroleum Co.* v. *Wisconsin*, 347 U.S. 672 (1954), the Supreme Court held that the Natural Gas Act applied to all independent producers of natural gas who made sales in interstate commerce. This was the first application of the regulatory features of the Act to independent producers. The effect of this decision on the Commission's regulatory effort was both immediate and spectacular, for *Phillips*, in effect, recognized that 3000 aditional companies were under the Act. The practice of making independent cost-of-service calculations for each of these companies rapidly proved to be so time-consuming that for a while it appeared that the regulatory process itself would be brought to a halt.[10]

In addition to the length of time required for the necessary calculations, rates based on individual company cost of service exhibited certain other deficienicies. First of all, largely speculative cost allocations made the rates obtained somewhat unrealistic.[11] Secondly, because oil and gas wells were

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[9] City of Chicago v. FPC, 128 U.S. App. D.C. 107, 110, 385 F.2d 629, 632 (1967), *cert. denied*, 390 U.S. 945 (1968). *See also* J. Bonbright, Principles of Public Utility Rates, 66-81 (1961); E. Nichols, Ruling Principles of Utility Regulation 1-9 (1955).

[10] Permian Basin Area Rate Cases, 390 U.S. 747, 758 (1968); Phillips Petroleum Co., 24 F.P.C. 537, 545-46 (1960). The problem was compounded by the fact that the Commission apparently declined to act on many rate increases pending the outcome in Congress of several bills designed to remove its jurisdiction over independent producers. The bills were vetoed. J. Landis, Report on Regulatory Agencies to the President-Elect, printed for use of the Senate Judiciary Committee, 86th Cong., 2d Sess. 7 (1960).

[11] Prior to 1961, natural gas was primarily a by-product of oil production. Technology prior to that time was insufficient to

typically the product of joint ventures in which several independent producers had an interest, rates based on individual company cost-of-service resulted in great anomalies in the prices paid to producers for gas by both pipeline companies and consumers.[12] Finally, unlike the case with the "traditional" public utilities, there was little relationship between an individual producer's expenditures and his income, for luck is an important factor in the discovery of gas as a result of any particular exploratory effort.[13] Together, the

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allow producers to search for gas alone with any degree of success. *See generally* Permian Basin Area Rate Proceeding, 34 F.P.C. 306, 325-29 (1964) (presiding examiner's decision). For that reason, it was difficult and somewhat unrealistic to attempt to allocate to gas production a portion of the total expenditure required for drilling an oil well, just as it would be to try to separate the costs of growing apple seeds from the costs of growing apples. *See* Permian Basin Area Rate Cases, 390 U.S. 747, 761 & n.25 (1968); 34 F.P.C. 306, 338 (1964) (presiding examiner's decision); Phillips Petroleum Co., 24 F.P.C. 537, 543-44 (1960). Though the Commission has recently conceded that cost allocation is never an exact science, Texas Gulf Coast Area Rate Proceeding, F.P.C. slip op. at 10-11 (No. 595, decided May 6, 1971), use of area rates does reduce the problems inherent in the process. Moreover, since some 80% of the income from production from a given well was attributable to oil, the rates set for gas were unlikely to have a significant effect on exploratory activity. 34 F.P.C. 306, 311 (1964) (presiding examiner's decision).

[12] If, for example, four different companies, each with a different cost-of-service, were producing gas from a single well, purchasers could pay four different prices for gas emanating from that single well. Phillips Petroleum Co., 24 F.P.C. 537, 544 (1960). While the desire to create a symmetrical price structure might not by itself permit the Commission to set any given rates, *see* City of Detroit v. F.P.C., 97 U.S. App. D.C. 260, 266 n.9, 230 F.2d 810, 816 n.9 (1955), elimination of such anomalies would seem to be a desirable end provided that it can be accomplished by means which fully comport with the aims of the Natural Gas Act.

[13] *See generally* Permian Basin Area Rate Cases, 390 U.S. 747, 756 & n.11 (1968); Sunray Oil Co. v. F.P.C., 364 U.S. 137, 160 (1960) (Harlan, J., dissenting); F.P.C. v. Hope Natural Gas Co., 320 U.S. 591, 649 (1944) (Jackson, J., dissenting).

above factors made questionable the wisdom of attempts to regulate the natural gas industry on the traditional basis of cost of service in a test year.

Recognizing the above deficiencies and spurred by the increasingly large administrtive burden with which it was faced, the Commission announced in a statement in 1960 that in the future all natural gas produced and sold *by independent producers* would be priced at the just and reasonable "area rate". It divided the country into twenty-three geographic areas and set initial or "guideline" prices for all gas produced from wells within each of the areas.[14] Full hearings were to be held to determine the just and reasonable rate for each area and the guideline prices were to be used until such determinations were made.

In the *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), the Supreme Court reviewed the Commission's first area rate determination, giving approval to both the area rate method or regulation and the prices which had been set.[15] As developed in the *Permian* proceeding, an area rate

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[14] Statement of General Policy No. 61-1, 24 F.P.C. 818 (1960). Three of the initial areas were consolidated at the commencement of the Permian Basin proceeding. 24 F.P.C. 1122 (1960). The prices contained in the Statement applied to both initial and increased prices. The Commission indicated that no certificate would be issued under § 7 of the Act if the proposed prices for sale of the gas exceeded the guideline prices and that all increases in existing prices would be suspended under § 4(e) if, as increased, the guideline prices were exceeded.

[15] Since the *Permian Basin* case, one other rate proceeding has completed the course of judicial review. Southern Louisiana Area Rate Cases, 40 F.P.C. 530 (1968); *aff'd*, 428 F.2d 407 (5th Cir.), *cert. denied*, 400 U.S. 950 (1970). At least two other proceedings have reached a decision by the Commission. Texas Gulf Coast Area Rate Proceeding, 39 U.S.L.W. 2653 (May 6, 1971); Hugoton-Anadarko Area Rate Proceeding, — F.P.C. — (No. 586, September 18, 1970).

is essentially a rate predicated on a composite rather than an individual cost-of-service. Cost data are gathered from all producers engaged in natural gas production in a given area and weighted average costs plus an appropriate rate of return are used to derive a price for gas produced in that area and sold in interstate commerce.[16] In addition to alleviating many of the problems associated with individual company cost of service, area rates were designed to spur the search for new deposits of natural gas. To this end, higher rates were allowed for "new" gas than were allowed for "old" or "flowing" gas.[17]

In the *Permian* case, and in the *Southern Louisiana Area Rate Cases*[18] which followed, area rates were applied only to gas produced and sold in interstate commerce by independent producers.[19] Pipeline companies which produced gas and used it on-system were not permitted to value such gas for rate making purposes at the area rates.

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[16] The rate, expressed in terms of cents per thousand cubic feet (Mcf) represents the cost of finding and producing new reserves of natural gas. 34 F.P.C. at 340-42. In the *Permian* case, both maximum and minimum permissible prices for new gas were fixed. In addition, certain adjustments to these prices were required depending on the quality of the gas produced. Permian Basin Area Rate Cases, 390 U.S. 747, 762-63 (1968).

[17] Gas produced after January 1, 1961 was considered "new" gas because much of the data concerning the cost of gas received by the Commission involved 1960 costs, because guideline policies had been established in 1960 and because 1961 marked the time at which it became possible to engage in directional searches, *i.e.*, searches for either oil or gas alone. 34 F.P.C. at 188-89. In the Southern Louisiana Area rate proceeding, a three-price system was established. 40 F.P.C. 530, 636 (1968).

[18] 40 F.P.C. 530 (1968), *aff'd*, 428 F.2d 407 (5th Cir.), *cert.* denied, 400 U.S. 950 (1970).

[19] About 70% of all gas produced for marketing in the United States is sold in interstate commerce. 34 F.P.C. 172-73. *See generally* FPC Annual Report 49-50 (1970).

Instead, the expenses incurred in production were included in the pipeline company's cost of service, along with the expenses incurred in obtaining the compression, transmission and other facilities needed for transporting the gas to market.[20]

The instant proceeding began as a part of the *Hugoton-Anadarko Area Rate Proceeding*[21] when the Commission issued an order enlarging the issues in that proceeding to include the question of whether on-system gas produced by a pipeline company or its affiliate should be valued for rate-making purposes on an area rate basis.[22] This issue was included in the *Hugoton-Anadarko* proceeding because the Commission believed that the area was one of considerable pipeline production activity and that the proceeding would thus be an "appropriate vehicle" for examination of the issue.[23] It soon became apparent, however, that pipeline production in the *Hugoton-Anadarko* area was not typical of pipeline production throughout the United States. Accordingly, on motion of the Commission's staff, the pipeline question was severed from the proceeding, and

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[20] Pipeline Production Area Rate Proceeding (Phase I), 42 F.P.C. 738, 745 (1969). Gas produced by an affiliate of a pipeline is treated for ratemaking purposes as if it were produced by the pipeline company itself. *Id.* at 754, 784-85. This accords with the treatment with such affiliates generally. *See* Mississippi River Fuel Corp. v. FPC, 102 U.S. App. D.C. 238, 243, 252 F.2d 619, 622, *cert. denied*, 355 U.S. 904 (1957); Union Prod. Co., 31 F.P.C. 41, 43-44 (1964). *But see* Panhandle Eastern Pipeline Co., 40 F.P.C. 98, 101 n.2 (1968); Union Prod. Co., 31 F.P.C. 503, 504 n.1 (1964). As used in the discussion which follows, the term pipeline company includes affiliates of pipeline companies.

[21] 30 F.P.C. 1354 (1963).

[22] 31 F.P.C. 1595 (1964).

[23] 35 F.P.C. 497 (1966).

a new inquiry, divided in two phases, was instituted.[24] The precise issue presented in Phase I, the only phase presently before us, was articulated by the Commission:

> What is the most appropriate pricing method to be applied to natural gas utilized in a pipeline's interstate system which is produced by the pipeline or its affiliated producing company from leases acquired after the date of determination of this issue.[25]

Thirty-seven pipeline companies, all those involved in the production of natural gas in more than an "incidental" way were made respondents,[26] and several pipeline affiliates were added at a later date.[27]

Following extensive hearings, the examiner issued his initial opinion holding that full application of area rates to pipeline production was not warranted at the present time. He found that

> the present regulatory method of cost-of-service for gas produced by pipelines and of area rates for gas

[24] An additional reason for severance was that testimony and exhibits in the Hugoton-Anadarko proceeding had produced no evidence concerning the impact on consumers of valuing pipeline production on the basis of area rates. 35 F.P.C. 498.

[25] 35 F.P.C. 499. The proceeding was divided into two phases primarily because of the functional role played by area rates in eliciting future supplies of natural gas. Different issues are thus presented when the question is whether area rates should be applied to future production activity than are present when the question is whether such rates should be applied to production from existing leases. *See* note 17, *supra*. Thus Phase II would relate to existing leases. 42 F.P.C. at 746.

[26] 35 F.P.C. 501 (1966).

[27] 35 F.P.C. 806 (1966).

produced by independent producers causes a disequilibrium in rates for future reserves of jurisdictional gas.[28]

He also found that

> [t]he advent of area rates for independent producers which is to eventually encompass most of the Continental United States is creating diverse economic and competitive factors which will influence the supply and demand of new jurisdictional gas . . . [making] it very difficult to maintain the rigid cost-of-service regulation indefinitely.[29]

Nevertheless, he concluded that

> a gas rate increase must not be brought about prematurely. The record . . . contains evidence to warrant only an interim balancing of equities, rate changes of only minor proportions.[30]

The Examiner therefore attempted to strike a balance which he felt would protect the public interest but which fell short of applying area rates to pipeline production.[31] Essentially, however, his decision represented an intermediate step in the transition from cost-of-service regulation to area rates, a transition which

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[28] 42 F.P.C. 797. Jurisdictional gas is gas sold in interstate commerce. *See* note 19, *supra*. Pipeline gas companies produce approximately 14% of all jurisdictional gas, or about 9.8% of all gas produced for marketing in the United States. *See* 42 F.P.C. 745.

[29] 42 F.P.C. 797.

[30] *Id.*

[31] The examiner's compromise solution involved allowing pipeline companies to retain some of the tax benefits which formerly inured to the benefit of consumers and allowing affiliates to make 10% of their on-system sales of gas at area rates. 42 F.P.C. 802.

he thought would be necessary at some time in the future.

The Commission disagreed with the examiner and decided that now was an appropriate time to make the change. It found that most of the anomalies resulting from cost-of-service pricing of gas sold by independent producers also resulted from use of this method to value gas produced by pipeline companies.[32] It also found that pipeline-owned reserves of natural gas were declining at a time when there were substantial indications of an impending gas shortage,[33] and concluded that, to the extent an increased stimulus was needed to spur the search for new deposits of natural gas, both independent producers and pipeline companies should be stimulated alike. Finally, the Commission concluded that utilization of an area pricing concept was the only way to stimulate gas production by pipeline companies and at the same time to protect consumers from bearing the full cost of unsuccessful or inefficient exploratory efforts. Accordingly, it promulgated a rule providing that gas produced by pipeline companies from leases acquired after October 7, 1969 would be valued for rate-making purposes at the same area rate applicable to independent producers in the area within which the lease was located.[34]

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[32] 42 F.P.C. 746; *see* notes 11-13, *supra*.

[33] The decline was both relative and absolute. The amount of gas reserves owned by pipeline companies declined 29.9% between 1958 and 1966. The percentage of total reserves owned by pipeline companies declined from 25% to 13% during the same period. 42 F.P.C. 747-48; *see* notes 63, 64 *infra*.

[34] 42 F.P.C. 754, *modified*, 42 F.P.C. 1093 (1969). The Commission's order is reprinted at Appendix A, *infra*.

Following a denial by the Commission of a motion for rehearing,[35] petitioner filed the instant petition for review, in support of which it advanced four main arguments: (1) The Commission improperly relied on evidence not contained in the record in reaching its decision; (2) the Commission, in light of the record before it, improperly abandoned cost-of-service valuation of gas produced by pipeline companies; (3) assuming area rates were appropriate for regulation of pipelines, the Commission erred in allowing such companies the same rate of return it allowed independent producers; and (4) the Commission did not give proper recognition to certain facets of the law applicable to income tax benefits.

II

Jurisdiction and Scope of Review

Before turning to the merits of petitioner's specific contentions, it is important to discuss briefly our jurisdiction and scope of review. This discussion is particularly in order because the parties are not in agreement as to the nature of the proceeding which led to the order presently before us: Petitioner claims that the proceeding was intended by the Commission, and understood by the parties, to be an "adjudicatory" one but that the Commission impermissibly changed it to a rule-making proceeding at the last minute.[36] The Commission and intervenors, on the other hand, claim that the proceeding was intended as, and understood to be, a "rule-making" proceeding from the outset.

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[35] 42 F.P.C. 1089 (1969).

[36] The two types of proceeding are distinguished in the Administrative Procedure Act: 5 U.S.C. § 551 (5), (7) (1970). As the following discussion indicates, however, the definitions contained in Section 551 are not always easily applied to a given fact situation.

From the premises thus advanced, both groups would have us draw certain allegedly inevitable conclusions.

In many cases, it is unnecessary, and even unwise, to classify a given proceeding as either adjudicatory or rule-making. The line between the two is frequently a thin one and resolution of a given problem will rarely turn wholly on whether the proceeding is placed in one category or the other. Moreover, obsession with attempts to place agency action in the proper category may often obscure the real issue which divides the parties and requires our resolution.[37]

The instant case is an example of the potential for confusion that may be caused by attempts at classification. It is quite clear to us that we are not faced with a borderline case and that the instant proceeding was both intended by the Commission to be and was conducted as a rule making proceeding from the date it was severed from the *Hugoton-Anadarko* proceedings. As required by the Administrative Procedure Act, notice of the proceedings was published in the Federal Register.[38] Comments were invited from interested parties and the issue before the Commission was succinctly described. That issue involved the most ap-

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[37] *See* NLRB v. Wyman-Gordon Co., 394 U.S. 759, 770-71 (1969) (opinion of Black, J.); Capitol Airways, Inc. v. CAB, 110 U.S. App. D.C. 262, 265, 292 F.2d 755, 758 (1961). *See generally* 1 K. DAVIS, ADMINISTRATIVE LAW TREATISE § 5.01 (1958); Shapiro, *The Choice of Rulemaking or Adjudication in the Development of Administrative Policy*, 78 HARV. L. REV. 921 (1965); Robinson, *The Making of Administrative Policy*, 118 U. PA. L. REV. 485 (1970).

[38] 31 Fed. Reg. 6075, *amended*, 31 Fed Reg. 7926 (1966). *See* generally 5 U.S.C. § 553(b) (1970). In its notice, the Commission stated that

> [a] separate proceeding entitled "Pipeline Production Area Rate Proceeding, Docket No. RP66-24, [&c] is hereby insti-

propriate method for valuing much of the gas produced by all pipeline companies in the future, the type of broad issue which particularly lends itself to rule-making proceedings.[39] The regulation, as adopted by the Commission, was published in the Federal Register.[40] From all indications, then, the proceeding fits into the category of rule-making, as even petitioner itself recognized in early arguments addressed to the Commission.[41]

Having determined that what we have before us is quite clearly a rule, it might appear that we have no jurisdiction to review the Commission's action at this

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tuted, pursuant to sections 4, 5, 10, 14, 15, and 16 of the Natural Gas Act, to determine the proper method to be used by the Commission in pricing natural gas produced by pipelines and/or acquired by them from their affiliated producers.

31 Fed. Reg. at 6076.

[39] *See* 5 U.S.C. § 551(4) (1970); American Airlines, Inc. v. CAB, 123 U.S. App. D.C. 310, 316, 359 F.2d 624, 630 *(en banc)*, *cert. denied*, 385 U.S. 843 (1966); *cf.* FPC v. Texaco, Inc., 377 U.S. 33 1964.

[40] 34 Fed. Reg. 17803 (1969), *amended*, 35 Fed. Reg. 1104 (1970); 5 U.S.C. § 553(d).

[41] II Joint Appendix 571 n.4. After the notice mentioned in note 38, *supra*, was promulgated, various pipeline companies moved to have the proceedings go forward on the basis of written data and exhibits submitted by the parties to the Commission. The Commission denied the motion, citing the need for a full evidentiary record, 36 F.P.C. at 956. We do not read this denial of the companies' request for informal rule-making as a statement that the proceeding was to be an "adjudication". *See generally* Automotive Parts & Accessories Ass'n, Inc. v. Boyd, 132 U.S. App. D.C. 200, 202-06, 407 F.2d 330, 332-36 (1968). At any rate, it is the substance of what the Commission has done that is controlling. *See* Citizens Communication Center v. FCC, Slip Opinion at 7-8 n.5 (No. 24,471, decided June 11, 1971); American Airlines, Inc. v. CAB, 123 U.S. App. D.C. 310, 317, 359 F.2d 624, 631 (1966, *en banc)*. In substance, the Commission has promulgated a rule.

point. Section 19(b) of the Natural Gas Act gives this court jurisdiction to review "orders" issued by the Commission in proceedings under the Act. In *United Gas Pipeline Co.* v. *FPC*, 86 U.S. App. D.C. 314, 181 F.2d 796, *cert. denied*, 340 U.S. 827 (1950), the court held that not all "orders" issued by the Commission were reviewable under Section 19(b). Faced there with a rule promulgated after non-evidentiary proceedings held in accordance with Section 4 of the Administrative Procedure Act, the court pointed to the wording of Section 19(b) and concluded that

> [o]n its face, the Act contemplates review of a decision based on evidence presented in a quasi-judicial proceeding before the Commission.

It then went on to hold that since it had before it "a rule directed to all companies similarly situated" and since it had "the Commission's binding assurance that the regulations will operate only prospectively . . . there is at the very least a strong presumption that the Commission has merely promulgated regulations of general applicability and not orders reviewable under Section 19(b)."[42]

Though the sentence last quoted might give rise to a contrary impression, the decision in *United Gas Pipeline* did not turn on the fact that the Commission had promulgated a rule rather than an order following an adjudicatory hearing.[43] The determining factor was the

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[42] *See also* FPC v. Metropolitan Edison Co., 304 U.S. 375 (1938); Shell Oil Co. v. FPC, 334 F.2d 1002, 1007 (3rd Cir. 1964); Amerada Petroleum Corp. v. FPC, 231 F.2d 461 (10th Cir. 1956).

[43] Nor did it turn on whether the order was "final." *Compare* Phillips Petroleum Co. v. FPC, 227 F.2d 470 (10th Cir. 1955). Here, also, there is little question that the Commission's action is "final" for purposes of review. For all practical purposes, it de-

absence of an evidentiary record which would allow meaningful review. The heavy weight placed on this factor is manifested both by the manner in which the court discussed Section 19(b) and by its suggestion that if petitioners were harmed by the rule itself, they could seek relief in the District Court *where an appropriate record could be compiled*. The Court's primary concern, then, was not with whether the order could be reviewed but with where.[44]

Whatever the continuing vitality of the *United Gas Pipeline* case in situations where no evidentiary record has been compiled, it does not control here, for we do have before us a full and complete evidentiary record of extensive hearings before the Commission. When the Commission's action is otherwise sufficiently "final", *United Gas Pipeline* does not preclude our review

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termines the method to be used in placing a value on gas produced by pipeline companies in all future pipeline rate cases. True it is that no impact in terms of increased or decreased rates will be felt until further action based upon the instant order is taken by either the Commission or a pipeline company. Nevertheless, the Commission has indicated that waiver of the instant rule which it has promulgated by order will be infrequently granted. 42 F.P.C. at 1091; *see* Southern Louisiana Area Rate Cases, 428 F.2d 407, 420 n.24 (5th Cir. 1970). *See generally* 18 C.F.R. §§ 1.7(b), 2.66 (a)(4) (1971). The controlling nature of the rule, the predominantly legal nature of the questions presented and the necessity for swift determination of the questions involved, all combine to make the order promulgating the rule final for purposes of review at this time. *See generally* Abbott Labs. v. Gardner, 387 U.S. 136 (1967); CBS, Inc. v. United States, 316 U.S. 407 (1942); Air Line Pilots Ass'n v. DOT, — F.2d — (5th Cir. July 12, 1971) (No. 29564); Atlantic Seaboard Corp v. FPC, 201 F.2d 568 (9th Cir. 1953); L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 418-23 (1965).

[44] *See also* Robertson v. FTC, 415 F.2d 49 (4th Cir. 1969); Division of Production, American Petroleum Institute v. Halaby, 307 F.2d 363 (5th Cir. 1962).

under section 19(b) when we are presented with such a record, whether the proceedings were adjudicatory or rule-making.[45]

The next question which arises concerns our scope of review. Here again the conclusion that we have a rule before us is likely to engender some confusion. There is some support for the proposition that the scope of judicial review of rules is much narrower than is the scope of review of an order stemming from an adjudicatory proceeding. One case which contains a clear expression of this view is *Superior Oil Co.* v. *FPC*, 322 F.2d 601 (9th Cir. 1963), *cert. denied*, 377 U.S. 922 (1964). In that case, Superior sought review of an order denying, without a hearing, its application for an amendment to its certificate of public convenience and necessity. The Commission's asserted basis for the denial was a regulation it had issued sometime previously, without an evidentiary hearing, which prohibited certain pricing provisions in contracts for the sale of natural gas. Superior advanced two arguments in support of its petition for review: (1) that the Commission had

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[45] As recent cases have indicated, there *is* a record available for review even when no evidentiary hearings have been held. Automotive Parts & Accessories Ass'n, Inc. v. Boyd, 132 U.S. App. D.C. 200, 206, 407 F.2d 330, 336 (1968). *Compare* Texaco Inc. v. FPC, 317 F.2d 796, 806 (10th Cir. 1963), *reversed*, 377 U.S. 33 (1964) *with* Pan American Petroleum Corp. v. FPC, 352 F.2d 241, 243 (10th Cir. 1965) (*Texaco* on remand). This court itself has expressly called into question the continuing vitality of *United Gas Pipeline*. Environmental Defense Fund, Inc. v. Hardin, 138 U.S. App. D.C. 391, 397 & n.27, 428 F.2d 1093, 1099 & n.27 (1970). *See also* Environmental Defense Fund, Inc. v. Ruckelshaus, — U.S. App. D.C. —, —, 439 F.2d 589, 591 (1971). In both these cases a result was reached contrary to the one reached in *United Gas Pipeline* although a similar judicial review statute was under consideration. *Compare* 15 U.S.C. § 717r(b) (1970) with 7 U.S.C. § 135b(d) (1970).

no authority to reject its petition for an amendment to its certificate without a hearing and (2) that the Commission's promulgation of the regulation was arbitrary and capricious.

The court held that, if the regulation were valid, the Commission was not required to give Superior a hearing before rejecting its petition. It then held that the regulation was not arbitrary and capricious, but in so doing, prescribed for itself a severely limited scope of review:

> . . . *In determining the propriety of rules of general application*, only a legal question is presented—whether on the factual premise upon which the Commission acted, the rule promulgated is unreasonable, arbitrary, capricious or discriminatory. If the factual premise itself were open to review then it would be necessary for all general rule-making to include a trial-like hearing.[46]

Other cases have seemed to prescribe a similar scope of review.[47] From these, it would follow that the scope of our review would turn on whether the instant order prescribed a rule of general applicability—which it does—or, at the very least, on whether an evidentiary hearing was *required* before it could be promulgated. Faced with a general rule, or a rule which required no evidentiary hearing before its promulgation, we would simply accept as true the premises asserted by the Commission as the basis for its action and then seek to determine whether the action bore some rational relation-

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[46] 332 F.2d at 619.

[47] *See, e.g.*, Pacific States Box & Basket Co. v. White, 296 U.S. 176, 186 (1935); United States v. George S. Buch & Co., 310 U.S. 371 (1940); Flying Tiger Line, Inc. v. Boyd, 244 F. Supp. 889, 892 (D.D.C. 1965).

ship to the regulatory objectives of the Natural Gas Act.[48]

We decline to follow this course for several reasons. In the first place, review would be a relatively futile exercise in formalism if no inquiry were permissible into the existence or non-existence of the condition which the Commission advances as the predicate for its regulatory action. A regulation perfectly reasonable and appropriate in the face of a given problem may be highly capricious if that problem does not exist. Secondly, rule-making is frequently spoken of as a "quasi-legislative" function.[49] While this is an accurate description, it means that, although the process leading to the promulgation of a rule frequently resembles the legislative process and although a rule frequently has an impact similar to that of a statute, rule-making is not fully equivalent to the action of the legislature. Clearly, rule-making is the action of a body subordinate to the legislature. That the same deference accorded "findings" of the legislature is not to be given the findings of the Commission is implicit in the law governing legislative delegation of authority.[50] Were

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[48] 332 F.2d at 619.

[49] *See* Corn Prod. Co. v. FDA, 427 F.2d 511, 517 (3rd Cir. 1970); Air Line Pilots Ass'n v. Quesada, 276 F.2d 892, 896 (2d Cir. 1960); 1 K. DAVIS, *supra* note 37, § 5.01.

[50] Willapoint Oysters, Inc. v. Ewing, 174 F.2d 676, 693 (9th Cir.), *cert. denied*, 338 U.S. 860 (1949) ("Rule-making is legislation on the administrative level, i.e., legislation within the confines (standard) of the granting statute as required by the Constitution and its doctrines of nondelegability and separability of powers."); *see* United States v. Robel, 389 U.S. 258, 274-75 (1967) (Brennan, J., concurring):

> Congress ordinarily may delegate power under broad standards . . . No other general rule would be feasible or desirable.

"findings" of the Commission in a rule-making proceeding automatically exempt from judicial review, the law governing delegation would also become little more than formalistic mutterings, for it makes little sense to require that the legislature articulate intelligible standards to govern agency action if realistic inquiry into whether those standards are being followed were foreclosed. Thirdly, the Commission has broad discretion to seek a given objective either through *ad hoc* adjudicatory proceedings or through rule-making.[51] To argue that, if the latter route is followed, judicial inquiry into

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> Delegation of power under general directives is an inevitable consequence of our complex society, with its myriad, ever changing, highly technical problems . . . It is generally enough that, in conferring power upon an appropriate authority, Congress indicate its general policy, and act in terms or within a context which limits the power conferred . . . Given such a situation, it is possible for affected persons, within the procedural structure usually established for the purpose, to be heard by the implementing agency and to secure meaningful review of its actions in the courts, and for Congress itself to review its agent's action to correct significant departures from Congress' intention.

See also American Power & Light Co. v. SEC, 329 U.S. 90, 104-06 (1946). Whether Congress has delegated power with the requisite precision

> depends not on the breadth of the definition of the facts or conditions which the administrative officer is to find but upon the determination whether the definition sufficiently marks the field within which the administrator is to act so that it may be known whether he has kept within it in compliance with the legislative will.

Yakus v. United States, 321 U.S. 414, 425 (1944).

[51] Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318, 343 (5th Cir.), *cert. denied*, 385 U.S. 847 (1966); *see* FPC v. Texaco, Inc., 377 U.S. 33 (1964). *See generally* SEC v. Chenery Corp., 332 U.S. 194, 203 (1947); American Airlines, Inc. v. CAB, 123 U.S. App. D.C. 310, 316 n.16, 359 F.2d 624, 630 n.16 (1966, *en banc*).

the factual basis for the agency's action is impermissible, is to say that in large measure the agency itself has the discretion to determine whether its action will be subject to meaningful review.

We conclude, then, that some inquiry into the factual predicate for rules promulgated by the Commission is required when review of those rules is sought here.[52] We further conclude that the nature of that inquiry depends not on whether the Commission has issued a rule or an adjudicatory order, but on the nature of the record presented to us for review.

As we mentioned at the outset, Sections 4, 5 and 7 of the Natural Gas Act provide the Commission with its primary tools for regulating the natural gas industry. All three sections contemplate action by the Commission after an evidentiary hearing primarily involving specific rates, charges or facilities. Section 16 of the Act, however, confers on the Commission broad power to "prescribe, issue, make, amend and rescind such orders, rules, and regulations as it may find necessary or appropriate to carry out the provisions of" the Act,[53]

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[52] This conclusion is implicit in various decisions of the Supreme Court and of this court. *E.g.*, American Trucking Ass'ns, Inc. v. United States, 344 U.S. 298, 310 (1953); National Broadcasting Co. v. United States, 319 U.S. 190, 224-25 (1943); Pacific & Southern Co. v. FCC, 132 U.S. App. D.C. 101, 405 F.2d 1371 (1968) (relying on WBEN, Inc. v. United States, 396 F.2d 601, 610-4 (2nd Cir.), *cert. denied*, 393 U.S. 914 (1968)); Automotive Parts & Accessories Ass'n v. Boyd, 132 U.S. App. D.C. 200, 407 F.2d 330 (1968). Whether such an inquiry is mandated, or even possible, in situations where minor agency action is taken without notice or hearing of any kind is a question not here decided, but such situations will probably arise only infrequently. *See* Texaco, Inc. v. FPC, 412 F.2d 740 (3rd Cir. 1969).

[53] 15 U.S.C. § 717o (1970).

and many of the same regulatory objectives which can be attained through *ad hoc* proceedings under Sections 4, 5 and 7 can also be attained through the issuance of general rules under Section 16. As in the case of many similar statutes, the procedures to be used in exercising the powers contained in Section 16 are not mentioned in the Act. The Administrative Procedure Act, however, does contain the appropriate procedures.[54] In particular, Section 4 (5 U.S.C. § 553) contains the minimum requirements which the Commission must meet before exercising its power under Section 16 of the Natural Gas Act. Section 4, *inter alia* and with certain exceptions not here relevant, provides for notice of the issues with which the Commission intends to deal and for participation by interested persons in the proceedings leading to promulgation of the rule.[55] Standing alone, Section 4 only requires that interested persons be given an opportunity to participate "through submission of written data, views or arguments with or without opportunity for oral presentation."[56]

As stated, however, Section 4 prescribes only the minimum procedural requirements for the Commission's exercise of power under Section 16. If it so chooses, the Commission may conduct, as it did here, a full evidentiary hearing of the type contemplated by Sections 7 and 8 of the Administrative Procedure Act,

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[54] Superior Oil Co. v. FPC, 322 F.2d 601, 608 (9th Cir. 1963), *cert. denied*, 377 U.S. 922 (1964); *see* Texaco, Inc. v. FPC, 412 F.2d 740 (3rd Cir. 1969); FPC v. Texaco, Inc., 377 U.S. 33 (1964).

[55] 5 U.S.C. § 553 (1970).

[56] 5 U.S.C. § 553(c) (1970). Where other specific statutes require an evidentiary hearing, the procedures contained in §§ 7 & 8 of the APA apply. *Id.*; *see* Siegel v. Atomic Energy Commission, 130 U.S. App. D.C. 307, 314-15, 400 F.2d 778, 785-86 (1968).

or may use any variant of such procedures.[57] Whatever procedure is utilized, a primary objective is the acquisition of information which will enable the Commission to carry out effectively the provisions of the Natural Gas Act. The ability to choose with relative freedom the procedure it will use to acquire relevant information gives the Commission power to realistically tailor the proceedings to fit the issues before it, the information it needs to illuminate those issues and the manner of presentation which, in its judgment, will bring before it the relevant information in the most efficient manner.

Thus while an important purpose of all proceedings before the Commission is the acquisition of information, it is quite obvious that the form the acquired information assumes may be vastly different depending on the procedures used by the Commission to gather it. The record in a Section 4 proceeding ordinarily will contain more generalized than specific information, may not contain information tested by cross-examination and will frequently contain much conclusory information based on data gathered by the interested parties.[58] For this reason, application of the substantial

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[57] Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318, 343 (5th Cir. 1966); *Legislative History of the Administrative Procedure Act*, S. Doc. 248, 79th Cong., 2d Sess. 250, 373 (1946); *cf.* American Airlines, Inc. v. CAB, 123 U.S. App. D.C. 310, 318, 359 F.2d 624, 633 (1966, *en banc*) ("It is part of the genius of the administrative process that its flexibility permits adoption of approaches subject to expeditious adjustment in the light of experience.") *See generally* Shapiro, *supra* note 37, at 936-37.

[58] *See Administrative Procedure in Government Agencies*, S. Doc. No. 8, 77th Cong., 1st Sess. 118 (1941); Automotive Parts & Accessories Ass'n, Inc. v. Boyd, 132 U.S. App. D.C. 200, 208, 407 F.2d 330, 338 (1968). *See generally* 1 K. DAVIS, *supra* note 37, at § 6.06.

evidence test, defined and conceptualized as it frequently is in terms of whether or not a directed verdict should be granted in a jury trial, to findings resulting from a Section 4 proceeding would be of scant utility. Juries are not often, if ever, called upon to deal with the kinds of generalized factual data which parties in a Section 4 proceeding present to a Commission which over the years has accumulated great quantities of information and acquired a recognized expertise upon the subject.

It does not follow, however, that review of an evidentiary record of proceedings before the Commission should be fundamentally distinguishable in objective from review of the record in proceedings where evidentiary hearings have not been held, for the availability of alternative routes to the same destination requires that all be charted with similar precision. Even in the absence of an evidentiary hearing, the reviewing court must canvass the "whole record" compiled before the Commission.[59] Its inquiry into the factual predicate for the action is to be "searching and careful", though, as in all cases, the court cannot substitute its judgment for the Commission's.[60] In sum, review of a non-evidentiary record must be "thorough, probing, [and] in depth."[61]

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[59] *See* Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 419 (1971); Administrative Procedure Act § 10, 5 U.S.C. § 706 (1970).

[60] Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971).

[61] *Id.* at 415; Automotive Parts & Accessories Ass'n. Inc. v. Boyd, 132 U.S. App. D.C. 200, 208, 407 F.2d 330, 338 (1968). Both cases illustrate the close nexus between review of an evidentiary and of a non-evidentiary record. In neither was an evidentiary resord required as a predicate to agency action, but in both exacting scrutiny of the record actually compiled was found to be a necessary ingredient of judicial review.

Application of no simple formula can avoid the process of judgment. In every case, the object of review is to determine whether a reasoned conclusion from the record as a whole could support the premise on which the Commission's action rests. The substantial evidence test is essentially an application of this general principle to a particular kind of record,[62] but, in all cases, reasoned conclusions are the hallmark of regularity.

The foregoing makes it unnecessary for us to determine whether an evidentiary hearing was required in this case, for the scope of our review does not turn on the answer to that question. Once we have satisfied ourselves that the minimum procedural requirements have been met by the Commission, our "searching and careful" review of its action must take full account of the record actually compiled before that body. When we have determined that the factual predicate for the Commission's action could be a reasoned conclusion from the record as a whole, that the factual predicate is one

[62] *See generally* Universal Camera Corp. v. NLRB, 340 U.S. 474 (1951); Corn Prod. Co. v. FDA, 427 F.2d 511, 514 (3rd Cir. 1970); L. JAFFE, JUDICIAL CONTROL OF ADMINISTRATIVE ACTION 600-04 (1965). The final report of the Attorney General's Committee on Administrative Procedure indicated that judicial review should take into account the nature of the evidence that it was practical to obtain on the issue under consideration. *Administrative Procedure in Government Agencies, supra* note 58, at 119. In large part, however, the procedural requirements which relevant statutes impose as a precedent to agency action reflect these practicalities. If, therefore, the minimum procedures required by statute have been fulfilled, it is not the function of the court to determine whether a different procedure or a different kind of evidence would have been better, but whether, on the basis of the record actually compiled, a reasoned conclusion could support the agency's action. *Cf.* American Airlines, Inc. v. CAB, 123 U.S. App. D.C. 310, 313-14, 359 F.2d 624, 627-28 (1966, *en banc*). *Compare, e.g.*, Pollack v. Simonson, 121 U.S. App. D.C. 362, 350 F.2d 740 (1965).

with which the Natural Gas Act permits the Commission to be concerned and that the Commission's action on that predicate is within its statutory authority, our function is at end. With these principles in mind, we turn to the specific arguments advanced by petitioner.

III.

Reliance on Extra-Record Information

Petitioner's first argument is that the Commission impermissibly relied on evidence not contained in the record in order to reach its decision. Specifically, petitioner claims that there was no evidence in the record to support the Commission's conclusion that a natural gas "shortage" was impending. It further claims, as was mentioned above, that the proceeding was "adjudicatory" and that the Commission was required to base its decision only on data contained in the record. From these two propositions, petitioner contends that the Commission's order is invalid.

The Commission referred to the gas supply situation at two points in its discussion. At the outset, it said that its decision in this case marked

> a turning point in the regulation of pipelines owning their own reserves, but it follows closely upon the development of area regulation for independent producers and a changing picture in the gas supply situation as shown by the record and other facts coming to our attention. In light of an apparent gas shortage we are concerned whether the pipelines will make an increased effort to explore for and develop new gas reserves. We are also concerned whether new gas supplies will be available to the consumers of gas served by the long pipelines. To attain these ends it may be incumbent upon us to modify traditional approaches

to regulation with respect to pipeline production in order to provide a regulatory climate conducive to an aggressive pipeline exploration program.[63]

After discussing other factors which led it to conclude that area rates should be applied to pipeline production, the Commission again adverted to the gas supply situation:

> We arrive at this conclusion at a time when there are indications of a shortage of gas and a threat of a greater shortage in the future. For instance, for the first time the American Gas Association reported that in 1968 net gas production exceeded the reserves added resulting in a decline in total proved reserves from 292.9 trillion cubic feet to 287.3 trillion cubic feet by the end of 1968.[8]
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> While the 1968 figures are not in the record, the present trend is reflected by the record. Preeminent are the reserve-production ratios showing the ratios of reserves to production during the year. This ratio, for the United States, with some slight ups and downs, has trended downward from 22.1 in 1955 to 14.8 in 1968. Of course, the reserves owned by pipeline producers are only a portion of the whole but pipeline production has not been progressing satisfactorily. In fact, the owned reserves of pipeline producers have declined 29.9 percent between 1958 and 1966, and, as a percentage of total reserves, have declined from 25 percent in 1958 to 13 percent in 1966. In spite of this trend, as argued by the Pipeline Production Group and other parties, the pipeline producers are capable of making a significant contribution to new gas supplies.[64]

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[63] 42 F.P.C. at 745.

[64] 42 F.P.C. at 747-48; *see* II Joint App. 498, 500.

[8] AGA Committee on Annual Gas Reserves; Report issued April 7, 1969.

From these remarks, it is apparent that the Commission did refer to some statistical material outside the record, although the precise nature of the material to which it referred is not clear.

It by no means follows, though, that what the Commission has done is impermissible. We have already rejected the notion advanced by petitioner that the instant proceeding was an adjudicatory one, a notion which constitutes the major premise in its syllogism.[65] In light of what we have said above, however, we decline to deal with this issue solely in terms of a dichotomy between rule-making and adjudication. In our view, the Commission's use of extra-record statistical data did not in any way unfairly deprive petitioner of any substantial right.

In the first place, there is in the record information concerning the steady decline in the overall reserve-production ratio [66] as well as the decline both relative

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[65] The discussion which follows makes unnecessary any inquiry into whether the Commission's reliance on extra-record statistical data was permissable simply because this was a rule-making proceeding, *compare*, California Citizen's Band Ass'n, Inc. v. United States, 375 F.2d 43,54 (9th Cir.), *cert. denied*, 389 U.S. 844 (1967), or whether the Commission was taking into account "legislative" as opposed to "adjudicative" facts. *See generally* American Airlines, Inc. v. CAB, 123 U.S. App. D.C. 310, 359 F.2d 624, 633 (1966); 1 K. DAVIS, *supra* note 37, § 15.03.

[66] This is the ratio of total known reserves of natural gas to annual production. Permian Basin Area Rate Cases, 390 U.S. 747, 816-18 (1968). The ratio has declined from 29.6 in 1950 to 13.3 in 1969, with the rate of decline accelerating over the past few years. FPC Annual Report 51 (1970). *See also* II Joint Appendix 465. It reached 11.9 in 1970. Texas Gulf Coast Area Rate Proceeding, FPC Slip Op. 12 (No. 595, decided May 6, 1971). A recent staff report predicts a further decline to 10.3 by 1973. FPC, Staff Report on Natural Gas Supply and Demand 11 (1969).

and absolute in reserves of natural gas owned by pipeline companies.[67] The significance of these data, of course, is not self-evident. Petitioner, for example, argues that movement of the reserve-production ratio is of little aid in predicting anything, while the Commission attaches somewhat more significance to it.[68] Recently, the Commission's staff completed a study which indicates that the ratio is a useful, if somewhat rough, measure of the adequacy of gas supplies.[69]

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[67] See note 33, *supra*.

[68] Southern Louisiana Area Rate Proceeding, 40 F.P.C. 530, 552 (1968); Permian Basin Area Rate Proceeding, 34 F.P.C. 159, 183-84 (1965). *See also* Southern Louisiana Area Rate Cases, 428 F.2d 407, 437-39 (5th Cir. 1970).

[69] FPC, Staff Report on Natural Gas Supply and Demand 7 (1969). The Staff gave more significance to the "critical" reserve-production ratio than it did to reserve-production ratios generally. The "critical" ratio is "the ratio at which increasing production can no longer be sustained at historical rates. . . . The significance of the critical [reserve-production ratio] is that when it is reached an area can no longer be relied on to deliver its share of increasing U.S. production requirements." *Id.* at 15. The Staff also indicated that the most important ratio for an early determination of whether future supplies of natural gas will be adequate is the findings-production ratio, *i.e.*, the ratio of new gas found to gas produced during a given year. As long as that ratio is 1.0 or higher, the Commission apparently feels that some decline in the reserve-production ratio is not of critical importance. *See* Permian Basin Area Rate Proceeding, 34 F.P.C. 159, 184 (1965); Permian Basin Area Rate Cases, 390 U.S. 747, 817 n.102 (1968). Significantly, then the Commission in the instant case indicated that the finding-production ratio dropped below 1.0 for the first time in 1968. Text at note 64, *supra*. It has remained below 1.0 since that time. Texas Gulf Coast Area Rate Proceeding, FPC Slip Op. at 11 n.7 (No. 595, decided May 6, 1971). In addition, the levels of annual exploratory drilling have also been declining over the past decade, FPC Annual Report 45 (1969), although 1969 marked what may be the beginning of a reversal of this trend. FPC Annual Report 51 (1970).

Interpretation of, and assignment of weight to, data such as these is a task which particularly calls for expert judgment. In interpreting such data and in making predictions based on them, the Commission must be expected to make use of the experience it has gained through years of dealing with the problem of the supply of natural gas. Frequently, statistics, scientific reports and studies will be amenable to various interpretations and effective regulation requires that the Commission bring to bear the full range of its knowledge, garnered from whatever source, in making the interpretation on which it bases important policy decisions.[70]

As we read the Commission's discussion, the extra-record material on which it relied was used chiefly to give some meaning to data concerning the supply situation which was contained in the record. In our view, this was not only permissible, but was action fully necessary to enable the Commission to carry out its statutory role.

In the second place, the question of whether existing gas supplies are adequate is not a novel one. As petitioner itself points out, the issue has been raised in numerous rate proceedings over the past fifteen years.[71]

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[70] NLRB v. Seven-Up Bottling Co., 344 U.S. 344, 348-49 (1953); Universal Camera Corp. v. NLRB, 340 U.S. 474, 490 (1951). *See* generally United States v. Pierce Auto Lines, 327 U.S. 515, 529-30 (1946); Interstate Power Co. v. FPC, 236 F.2d 372, 385-86 (8th Cir. 1956); Director, United States Bureau of Mines v. Princess Elkhorn Coal Co., 226 F.2d 570 (6th Cir. 1955); 2 K. DAVIS, *supra* note 37, at 342.

[71] Reply Brief for Petitioner at 28. *See also* Southern Louisiana Area Rate Cases, 428 F.2d 407, 438 nn. 97-98 (5th Cir. 1970). *Compare* Moss, Is a Gas Shortage in Prospect, Public Utilities Fortnightly, October 14, 1965, at 30 *with* Russell, The Adequacy of Natural Gas Reserves, *id.* at 60.

To the extent that the two-price approach to area rates utilized in the *Permian* case is designed to *stimulate* the search for natural gas, the question of the adequacy of present supplies is necessarily involved in every proceeding which deals with area rates.[72] Many issues which the parties agreed to explore in the instant proceeding implicitly involved the adequacy of existing supplies of gas.[73] The issue thus was clearly present in

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[72] *See* Southern Louisiana Area Rate Cases, 428 F.2d 407, 434-44 (5th Cir. 1970). To the extent that projected supplies are sufficient to meet foreseeable demand, there would seem to be no need for stimulating a greater search for new supplies. Yet the Commission has indicated its concern with future supply in all of the area rate proceedings which have been concluded to this date. Texas Gulf Coast Area Rate Proceeding, Slip Op. at 11-19 (No. 595, decided May 6, 1971); Hugoton-Anadarko Area Rate Proceeding, Slip Op. at 19-22 (No. 586, decided September 18, 1970); Southern Louisiana Area Rate Proceeding, 40 F.P.C. 530, 632-36 (1968); Permian Basin Area Rate Proceeding, 34 F.P.C. 159, 185 1965).

[73] *E.g.*, 42 F.P.C. 813:

> Should pipelines be encouraged to engage in greater exploration and development activities or, in the alternative, to purchase acreage of proven reserves? . . .
>
> Assuming that pipeline exploration and development of production should be encouraged, would that policy objective be best furthered by pricing pipeline production on an area rate basis or by continuing regulation on traditional cost of service principle [*sic*]? . . .
>
> If pipeline (and affiliate) production is to be neither encouraged nor discouraged, what is the most appropriate pricing method to be used for such production.

42 F.P.C. 814:

> To what extent, and in what respects, do pipelines operate their production properties in a different manner than do independent producers with respect to: (a) reserve to production ratio. . . . In addition, the supply issue was discussed by several of the witnesses in the proceeding before the examiner. E.g., I Joint Appendix 87-88, 199-200.

the case and petitioner was not deprived of the opportunity to present relevant information by lack of notice that the issue was there.[74]

Finally, it must be remembered that the sole issue here involves the proper *method* to be followed in placing a value for rate-making purposes on much of the new gas to be produced by pipeline companies. The actual value permissible for such gas will be determined by future rate proceedings for individual producing areas. In the context of these future proceedings, petitioner and others will have an opportunity to explore in some detail the extent of the anticipated gas shortage as well as the precise amount of incentive needed to combat it.[75] The order currently before us represents only the Commission's determination that, to the extent a gas shortage is threatened, increased exploration and production will be needed from both independent producers and pipeline companies alike, and that the area rate concept is the most efficient method of stimulating such increases and at the same time protecting consumers from bearing the full cost of some unsuccessful exploratory efforts. Thus, the precise magnitude of the possible gas shortage was not fully explored, was not necessary to determine before the Commission reached its decision and both can and should be examined by parties to future area rate proceedings. For

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[74] *See* Permian Basin Area Rate Cases, 390 U.S. 747, 808 n.89 (1968); Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318, 341 (5th Cir. 1966); Mississippi River Fuel Corp. v. FPC, 82 U.S. App. D.C. 208, 211, 163 F.2d 433, 436 (1947). *Compare* American Louisiana Pipe Line Co. v. FPC, 120 U.S. App. D.C. 140, 143, 344 F.2d 525, 528 (1965).

[75] Permian Basin Area Rate Proceeding, 43 F.P.C. 899, 901 (1970); Offshore Southern Louisiana, Federal Domain & Disputed Areas Area Rate Proceeding, 41 F.P.C. 378 (1969).

the above reasons, we conclude that petitioner's claim that the Commission erred in referring to data not contained in the record is without merit.[76]

IV

Departure from Cost of Service Pricing

Petitioner's next argument is that "on this record existing legal standards compel the continuance of cost-of-service regulation of the [on-system] gas produced by interstate pipeline companies or acquired from their affiliates." Though petitioner spends much time discussing the decisions of various courts which have held that individual cost-of-service regulation is *appropriate*, we do not understand the main thrust of the argument to be that employment of this method of regulation is *compelled* either by the Natural Gas Act or by the Constitution.[77] Rather, the argument is

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[76] Two cases relied upon by petitioner are inapposite. In Cinderella Career & Finishing Schools, Inc. v. FTC, 138 U.S. App. D.C. 152, 425 F.2d 583 (1970), the Commission completely disregarded the record of the proceedings before the examiner and proceeded to examine the issues before it *de novo*. Even if we were to assume that the procedural standards articulated in Cinderella fully applied to this case, it is evident that the Commission here did not disregard the record compiled before the examiner. The second case, Public Serv. Comm'n of New York v. FPC, 141 U.S. App. D.C. 174, 436 F.2d 904 (1970), was one in which the court remanded to the Commission because it had failed to articulate fully the basis for its decision. Here petitioner is not contending that the Commission failed to articulate the reasons for its actions. The contention is that the Commission's action was based on information which it had no right to consider. As the foregoing discussion indicates, we disagree with that contention.

[77] Such an argument, at this late date, would be difficult to maintain. *See generally* Permian Basin Area Rate Cases, 390 U.S. 747, 776-77 (1968); Colorado Interstate Gas Co. v. FPC, 324 U.S. 581, 589 (1945); FPC v. Hope Natural Gas Co., 320 U.S. 591, 602 (1944); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 586

that the decision of this court in *City of Detroit* v. *FPC*, 97 U.S. App. D.C. 260, 230 F.2d 810 (1955), *cert. denied*, 352 U.S. 829 (1956), places a heavy burden on the Commission to justify its departure from individual cost-of-service regulation, a burden which it has not met in this case.[78]

In the *City of Detroit case*, this court reviewed an order issued by the FPC following an investigation into the lawfulness of rates charged by Panhandle Eastern Pipeline Company. Insofar as its action is here relevant, the Commission held that gas produced by Pan-

(1942); Southern Louisiana Area Rate Cases, 428 F.2d 407, 423 n.34 (5th Cir.), *cert denied*, 400 U.S. 950 (1970). As was observed by the Court of Appeals for the Fifth Circuit, "[f]rom start to finish the Permian Basis litigation occupied eight years and caused every conceivable criticism of the area regulatory process, of whatever merit, to be presented and considered." Hunt Oil Co. v. FPC, Slip Op. at 2 (No. 27457, decided April 21, 1970).

[78] A subsidiary argument advanced by petitioner is that statistics in the record indicate that costs for each pipeline company incurred in production activity diverge from median costs to a far greater extent than do costs for independent producers. *See* I Joint Appendix at 66, 352-53; II Joint Appendix at 431, 516-24. Petitioner argues that for this reason also area rates should not be applied to pipeline companies. The Commission rejected this argument, holding that these statistics reflected to a large extent the different costs prevailing during the different historical periods when pipelines entered the field of gas production. It concluded that future costs for both pipeline companies and independent producers would be similar and there was therefore little reason to suppose that historical cost divergences would continue. 42 F.P.C. at 748. It is, of course, true that "[t]he premise of group proceedings . . . is that evidence pertaining to a group is typical of its individual members." Chicago & North Western Ry. v. Atchison, T. & S. F. Ry., 387 U.S. 326, 342 (1967); *see* New England Divisions Case, 261 U.S. 184, 199 (1923). Assuming that the data to which petitioner refers means that median costs are not "typical," the Commission properly refused to accept them at face value and relied instead on other data which suggested that future costs would be very similar. *Compare* Southern Louisiana Area Rate Cases, 428 F.2d 407, 442 & n.113 (5th Cir. 1970).

handle and used on-system would be valued for rate-making purposes at its "field price".[79] instead of through the cost of service method. The effect of this determination was twofold: (1) It substituted the forces of the market for producer costs as the basis on which the "justness" and "reasonableness" of given rates would be determined and (2) it raised the price being charged for gas by Panhandle 1.3 cents per Mcf over what it would have been under cost-of-service regulation. The Commission justified its departure from the traditional method of regulation on several grounds, among them that the old method did not sufficiently encourage the discovery and development of natural gas by pipeline companies.[80]

This court reversed. After mentioning that "the primary aim of the [Natural Gas] Act . . . is 'to protect consumers against exploitation at the hands of natural gas companies,'"[81] the court said:

> The [increase] here allowed is not brought into relationship by the evidence and findings with the purposes for which it is granted except that it affords a larger revenue to Panhandle than otherwise it would have.

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[79] The field price was computed from the "'weighted average arm's length prices' established by federally unregulated bargaining for similar gas in the fields." City of Detroit v. FPC, 97 U.S. App. D.C. 260, 263, 230 F.2d 810, 813 (1955).

[80] Other reasons included the Commission's conclusion that cost-of-service regulation tended to accelerate unduly consumption of natural gas and that pipelines should be given incentives to develop their own reserves so that they would not be forced to rely completely on others for needed supplies. City of Detroit v. FPC, 97 U.S. App. D.C. 260, 266, 230 F.2d 810, 816 (1955). Presumably the second factor was also intended to allow the pipelines to bargain with other suppliers to obtain the best possible prices for gas. Apparently such bargaining has not been extensive. Permian Basin Area Rate Cases, 390 U.S. 747, 793 & n.63 (1968).

[81] City of Detroit v. FPC, 97 U.S. App. D.C. 260, 263, 230 F.2d 810, 815 (1955); *accord*, Phillips Petroleum Co. v. Wisconsin, 347

> This is not an adequate basis for bringing the resulting rates within the "just and reasonable" standards of the Act. . . . When the [field price] method is used the evidence and findings must show that the increase in rates thus caused *is no more than is reasonably necessary for the purposes advanced for any increase.*[82]

Petitioner contends that the Commission has not made the showing required by the emphasized language from *City of Detroit.*

In order to properly evaluate petitioner's contention in this regard, we look first to the court's own explanation of the position it took in *City of Detroit* and to its definition of "increase."

> [W]hen we refer to an "increase" we mean an increase in the rates above those which would result from use of the conventional rate base method. For though we hold that method not to be the only one available under the statute, it is essential *in such a case as this* that it be used as a basis of comparison. It has been repeatedly used by the Commission, and repeatedly approved by the courts, as a means of arriving at lawful—"just and reasonable"—rates under the Act. Unless it is continued to be used, at least as a point of departure, the whole experience under the Act is discarded and no anchor, as it were, is available by which to hold the terms "just and reasonable" to some recognizable meaning.[83]

U.S. 672, 685 (1954) (Frankfurter, J., concurring); FPC v. Hope Nat. Gas Co., 320 U.S. 591, 610 (1944); Cities Service Gas Co. v. FPC, 424 F.2d 411, 417 (10th Cir. 1969), *petition for cert. dismissed,* 400 U.S. 801 (1970).

[82] 97 U.S. App. D.C. at 268, 320 F.2d at 818 (emphasis added).

[83] *Id.* at 268-69, 320 F.2d at 818-19 (emphasis added). Noteworthy is that here, unlike the case in *City of Detroit*, there is no conclusive evidence that the shift to area rates will definitely produce a price increase.

The necessity for an anchor to "hold the terms 'just and reasonable' to some recognizable meaning" is plain, for the words themselves have no intrinsic meaning applicable alike to all situations. Moreover, a rate which is just and reasonable to a producer of natural gas is not necessarily one which is just and reasonable to the consumer. When the inquiry is on whether the rate is reasonable to a producer, the underlying focus of concern is on the question of whether it is *high* enough to both maintain the producer's credit and attract capital. To do this, it must, *inter alia*, yield to equity owners a return "commensurate with returns on investments in other enterprises having corresponding risks," [84] as well as cover the cost of debt and other expenses. These standards can be used to evaluate the justness and reasonableness of a given rate to the producer regardless of the method used to determine what the rate will be. As has been indicated, however, the primary purpose of the Natural Gas Act is to protect consumers.[85] Thus when the inquiry is whether a given rate is just and reasonable to the consumer, the underlying concern is whether it is *low* enough so that exploitation by the producer is prevented. Accordingly, the Commission must weigh the sometimes conflicting interests of both producer and consumer before it can say that a particular rate is "just and reasonable" within the meaning of the Natural Gas Act.

The main concern of the court in *City of Detroit* was that wholesale abandonment of a cost-oriented approach to rate regulation would also be the abandon-

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[84] FPC v. Hope Nat. Gas Co., 320 U.S. 591, 603 (1944). *See generally* Lxventhal, *Vitality of the Comparable Earnings Standard for Regulation of Utilities in a Growth Economy*, 74 YALE L.J. 989 (1965)..

[85] Cases cited note 81, *supra*.

ment of the long utilized point of departure for analysis of the reasonableness of a given rate to the consumer. While rather concrete factors such as the ability to maintain and attract capital are available to gauge whether a rate is just and reasonable to a producer, no factors apart from producer costs are available to guide efforts to make that determination from the standpoint of the consumer. Thus the court feared that, if a rate based on market prices were not compared to one based on producer costs, the entire framework for evaluation of the reasonableness of the rate from the standpoint of the consumer would be lost,[86] leaving without protection the segment of society which was supposedly the prime beneficiary of the Natural Gas Act's system of regulation.

The same problems are not present when area rates are substituted for individual cost-of-service. As we indicated earlier, area rates are essentially rates based on composite cost of service for all producers in a given geographic area. Producer costs thus remain at the heart of the regulatory system. Moreover, a composite cost system of regulation has provided a workable method of setting rates just and reasonable to both producers and consumers in other areas of regulated

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[86] This is not to say that non-cost factors are an impermissible *ingredient* of a rate structure. *See* Permian Basin Area Rate Cases, 390 U.S. 747, 815-16 (1968). In limited circumstances, non-cost factors may themselves be adequate to protect the public interest. *See* United Gas Improvement Co. v. Callery Properties, Inc., 382 U.S. 223, 227-30 (1965); Atlantic Ref. Co. v. Public Serv. Comm'n, 360 U.S. 378, 391 (1959). In most circumstances, however, costs provide a framework within which non-cost factors can be considered and it is this framework which normally gives the terms "just and reasonable" some meaning from the standpoint of the consumer.

industry,[87] Finally, the Commission found that use of area rates would permit firmer control over the rates charged by pipeline companies than was possible under cost-of-service regulation and at the same time would provide a stimulus for increased production.[88]

In sum, this case is not a "case such as" *City of Detroit*, for abandonment of cost oriented regulation is not here proposed. Thus, while it remains true that rates must be "just and reasonable," we see no necessity for defining those terms by the relationship that an area rate bears to a rate computed under individual cost-of-service. Since no actual rates are before us at this time, what we have said disposes of petitioner's contention in this regard.

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[87] *See* Permian Basin Area Rate Cases, 390 U.S. 747, 769 (1968). The Supreme Court found little difficulty in harmonizing the *City of Detroit* case with the concept of area rates. Wisconsin v. FPC, 373 U.S. 294, 310 n.16 (1963).

[88] In both the Permian Basin Area Rate Cases, 390 U.S. 747, 792 (1968) and the Southern Louisiana Area Rate Cases, 428 F.2d 407, 435 & n.87 (5th Cir. 1970), the courts indicated that in the future the Commission should indicate more precisely the consequences its orders would have on the natural gas industry. In this case, we think that the Commission has been as precise as the nature of its inquiry permits and the scope of its rule requires for it is difficult in the context of this case to determine the precise consequences of the shift to area rate valuation of pipeline produced new gas. More thorough consideration of the expected consequences will be possible in the context of an actual rate case, for it is the price level actually reached rather than the method of computing it that has the most effect on both the effectiveness of incentives and the pocketbooks of consumers. Cf. Permian Basin Area Rate Cases, 390 U.S. 747, 797-98 (1968).

V.

Rate of Return Component

Petitioner next contends that, even if area rates may be employed by the Commission to regulate the price of gas produced by pipeline companies, the same rate-of-return component cannot be used to set the actual rates for gas produced by independent companies and pipeline companies.[89] If the same component is used, petitioner argues, pipeline companies will receive an enormous and unreasonable yield on the equity capital invested in their pipeline operations.[90]

On the surface, at least, petitioner's argument has some appeal. Petitioner points first to the fact that in both the *Permian Basin* and *Southern Louisiana* cases, cases which dealt only with rates applicable to independent producers, the Commission fixed a rate of return on capitalized investment at 12%. Petitioner then indicates that the record in this case shows that independent producers employ, on the average, a much

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[89] Petitioner contends that if the 12% overall rate of return component included in the Permian Basin and Southern Louisiana area rates is applied to pipeline companies, the yield to equity owners on the capital invested in production activity will range from 20% to 40%. Brief for Petitioner at 45. We do not understand this contention to be that any equity shareholder will actually receive anything approaching this yield on his actual investment since, among other things, a pipeline company's investment in production activity is only a part of its total investment. *See, e.g.*, I Joint Appendix 329; II Joint Appendix 512 (about 10%).

[90] II Joint Appendix 537 contains a table providing one comparison of the yield on equity to pipelines and independent producers engendered by the same overall rate of return. Prepared by the Pipeline Production Group, the table indicates that 12% overall rate of return on the rate base would yield 17.71% to equity of a "typical" pipeline company and 13.86% to equity of a "typical" independent producer.

higher percentage of equity capital than do pipeline companies. From this it follows, in petitioner's view, that a 12% overall rate of return results in a far greater yield on equity to a pipeline company than to an independent producer. This same result will allegedly occur each time the same rate of return is used for both pipeline companies and independent producers.[91]

Petitioner also maintains that application of a 12% rate of return to pipeline companies would be circular. As it points out, in the *Permian Basin* case the Commission determined that the average pipeline company received an overall rate of return of 6.5% which yielded 12% on equity.[92] Considering this yield, the somewhat greater risks inherent in production activity alone and the larger percentage of equity capital employed by the average independent producer, the Commission determined that a 12% overall rate of return, yielding about 13.5% on equity,[93] would be appropriate for independent producers.[94] Petitioner thus argues that 12% was chosen as an appropriate rate of return in *Permian Basin* in part to place independent producers

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[91] The Commission's staff essentially agreed with this position and urged the Commission to apply area rates to pipelines but to use a separate rate-of-return component in calculating those rates. 42 F.P.C. at 749.

[92] 34 F.P.C. at 201.

[93] 34 F.P.C. at 345 (presiding examiner's decision).

[94] 34 F.P.C. at 204. The Supreme Court noted with seeming approval this method of arriving at a 12% figure, holding that the resulting return would be sufficient to maintain the financial integrity of the producers and would not exceed their proper financial requirements. Permian Basin Area Rate Cases, 390 U.S. 747, 806-08 (1968). It noted, however, that this so-called comparable earnings test was not the only one available for setting rates. *Id.* at 806. *See also* Southern Louisiana Area Rate Cases, 428 F.2d 407, 424 n.38 (5th Cir. 1970); Leventhal, *supra* note 84.

on a parity with pipeline companies. To now apply a 12% rate of return to pipeline production activity under the guise of placing the return from such activity on a parity with that received by independent producers, is, in petitioner's view, to move in circles.

A close look at what the Commission has done, however, makes the surface anomalies disappear. In the first place, under the instant rule, area rates will apply to pipeline companies only with regard to gas produced from leases acquired after October 7, 1969.[95] The cost of such production must therefore be borne largely by "new" money. That pipeline companies may have been able to finance their production activities with a large percentage of low-cost debt in the past[96] is no assurance that they will be able to do so in the future. It is a matter of common knowledge that interest rates on new money have risen sharply in the last few years. Therefore, past financing experience is not a factor which is entirely determinative of the issue before us.

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[95] Exceptions were made for leases acquired from other pipelines or affiliates after the date of the Commission's decision. 42 F.P.C. at 1093. The Commission also provided that pipeline companies could make a showing of "special circumstances" justifying an exemption from area rate treatment. *Id.* at 1093-94. While it did not specify what such special circumstances might be, it did indicate that simple inability to recover expenses under the area rate method would not be such a circumstance. 42 F.P.C. at 1091. *See also* Permian Basin Area Rate Cases, 390 U.S. 747, 770-72 (1968); Southern Louisiana Area Rate Proceeding, 40 F.P.C. 530, 614-19.

[96] While much of the embedded debt is relatively low cost, one may expect that some of the oldest and cheapest will have to be replaced in the next few years at higher rates. *See* Panhandle Eastern Pipeline Co., 40 F.P.C. 98, 105 (1968); Natural Gas Pipeline Co., 40 F.P.C. 81, 88 (1968). The Commission has noted the recent rise in interest rates. FPC Annual Report 50 (1970).

What is relevant is the amount it will cost the pipelines in the future to produce gas from new leases.[97]

The Commission was not convinced that the production of natural gas in the future could be accomplished more cheaply by pipeline producers that it could be by independents. While conceding that certain elements of pipeline production tended to be less expensive than corresponding elements of independent producer operations, the Commission concluded that aggregate costs, including costs of capital, would be similar. The record supports this conclusion. Many out-of-pocket expenditures are the same for both independent producers and pipeline companies and many wells are the product of joint ventures between the two groups. In addition, as just noted, the cost of debt capital has been rising over the past few years, making somewhat doubtful the proposition that future production operations can be accomplished through the use of "lost cost" debt. In fact, there was evidence to indicate that recent debt issues for both independent producers and pipeline companies had similar rates of interest and other terms. Moreover, there was also evidence to indicate that pipeline companies with large percentages of debt in their capital structures might be in a less advantageous position with regard to raising more capital through the use of debt than were independent producers which did not have such high percentages of debt.

Even if the total costs for the two groups are not precisely similar, however, the actual rates set in area rate

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[97] In this connection, the examiner concluded:

> Historical costing methods, which roll in new and old production expenses distort the almost certain fact that pipeline produced new gas for all companies . . . is about as costly as average independent production.

42 F.P.C. at 799.

proceedings are based on data gathered from both independent producers and pipeline companies. Thus, any differences in cost, including costs of capital, between the two groups, like differences within them, will be taken into account before the rates are set. Naturally some independent producers and some pipeline companies will benefit from the rate so determined more than will others but disparity in benefit does not preclude use of a single area price structure for all.[98]

The circles petitioner seeks to draw are broken largely by changed circumstances, for the Commission has determined that the past experience of pipeline companies does not paint a wholly accurate picture of the future cost of producing gas from new leases. As is evident from the above comments, however, the Commission's decision to allow pipeline producers the same rate of return on production investment allowed independent producers is based on its *prediction* that both groups will have similar costs in the future. Similarly, the record before the Commission largely emphasized an upward trend which would extend into the future. If future costs for the two groups are significantly different—if the Commission's prediction turns out to be unfounded—then the premise for its decision with regard to the appropriate rate of return will not exist. In that event, costs incurred by independent producers cannot be averaged with those incurred by pipeline companies to derive a just and reasonable rate for

[98] There was testimony in the record to the effect that capital will usually cost a pipeline company less than it will cost an independent producer because the return from transmission activity makes the former investment a safer one. *E.g.*, I Joint Appendix 17, 29, 32, 81, 133-34, 168; II Joint Appendix 436. However, there was also evidence from which the contrary conclusion could be drawn. *E.g.*, I Joint Appendix 138-39, 329; II Joint Appendix 534.

both. *See United States* v. *Abilene & Southern Ry.*, 265 U.S. 274, 290-91 (1924); *cf. ICC* v. *Mechling*, 330 U.S. 567, 583 (1947); *The New England Divisions Case (Akron, C. & Y. Ry. Co.* v. *United States, et al.)*, 261 U.S. 184 (1923).

Thus the Commission must continually re-evaluate is prediction as experience accumulates. In an actual area rate proceeding, the Commission may start from the premise that the same rate of return should be applied to the production investment of both independent producers and pipeline companies in the area under consideration. However, our decision does not preclude any proper party from showing that production costs for the two groups are significantly different and that, as a result, each group should receive a different rate of return on its production investment. Essentially, then, we conclude that the Commission's decision to allow pipeline producers the same rate of return on new production as it allows independent producers can be a starting point only and that the propriety of actually allowing the two groups a single rate of return will have to be determined on the basis of the facts developed in an actual area rate case.

VI

Treatment of Income Tax Benefits

Petitioner's final argument concerns the treatment by the Commission of certain income tax benefits emanating from pipeline production activity. Petitioner argues that the Commission's failure to modify the area rates by applying separate income tax components to each pipeline company violates the "actual taxes paid" principle.

For purposes of ratemaking, income taxes are treated as costs incurred in the operation of the enterprise.[99] Those engaged in the production of natural gas for a long time argued before both the Commission and the courts that the proper tax element of their rates was the tax that would have been paid but for certain deductions provided by the Internal Revenue Code, chiefly those for depletion,[100] intangible expenses[101] and accelerate depreciation.[102] The reasoning behind these arguments was that, in granting such deductions, Congress sought to provide an incentive for participation in the production of a wasting asset. Only if the companies engaged in production of natural gas were allowed to retain the tax savings accruing from these provisions, the argument continued, would the congressional purposes be given full effect.

Almost uniformly, this reasoning was rejected.[103] While it could not be contested that Congress intended to provide incentives through the above deductions, neither could it be contested that the Commission itself had the duty under the Natural Gas Act of setting

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[99] There may be some question concerning whether it is accurate to refer to taxes as "costs". Nevertheless, they do have the same effect on rates as other costs incurred in carrying on the enterprise. *See* City of Chicago v. FPC, 128 U.S. App. D.C. 107, 111, 385 F.2d 629, 633 (1967), *cert. denied*, 390 U.S. 945 (1968).

[100] Internal Revenue Code of 1954, §§ 611-13, *as amended*, Tax Reform Act of 1969, Pub. L. No. 91-172, § 501, 83 Stat. 629.

[101] Internal Revenue Code of 1954, § 263(c).

[102] Internal Revenue Code of 1954 § 167; *as amended*, Tax Reform Act of 1969, Pub. L. No. 91-172, §§ 441, 521(d), 83 Stat. 625, 653.

[103] *E.g.*, City of Lexington, Ky. v. FPC, 295 F.2d 109 (4th Cir. 1961); El Paso Nat. Gas Co. v. FPC, 281 F.2d 567 (5th Cir. 1960), *cert. denied*, 366 U.S. 912 (1961).

rates which were just and reasonable. Widely accepted principles of ratemaking provided that an allowance both for incentive and for depletion of a wasting asset be included as an element of cost on which the rate was based regardless of the tax laws. From this, it followed that the proper tax element in a rate was the amount of taxes actually paid. Savings stemming from depreciation, depletion and intangible expense deductions were thus required to "flow through" the company to the purchaser in the form of lower rates. In addition, where such deductions were greater than a pipeline company's net income from production activity, the company was required to use the excess deductions to reduce the taxes payable on income from transmission activity. Were this not done, the producer would receive, in effect, the same incentives twice.[104]

Petitioner claims that application of area rates to pipeline companies would violate this "actual taxes paid" principle. Under the area rate concept, it argues, the tax element of the rate is calculated on an area and not on an individual basis. As a result, a company which pays less taxes than the average company producing gas in the area retains for itself tax savings

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[104] Initially, savings resulting from depletion and intangible deductions were distinguished from savings resulting from accelerated depreciation under § 167(b)(2) on the ground that the former were true savings while the latter were only deferrals. *See* City of Detroit v. FPC, 97 U.S. App. D.C. 260, 230 F.2d 810 (1955); cases cited note 103, *supra*. The Commission later changed its views on accelerated depreciation, holding that, in an expanding industry, savings resulting from accelerated depreciation were true savings and not simply deferrals. City of Chicago v. FPC, 128 U.S. App. D.C. 107, 385, F.2d 629 (1967); Alabama-Tennessee Natural Gas Co. v. FPC, 359 F.2d 318 (5th Cir. 1966).

which petitioner argues must flow through to the consumer.[105]

In our view, the answer to petitioner's contention is to be found in the principle mentioned above that, for rate-making purposes, taxes are considered nothing more and nothing less than a cost of doing business. No hypothetical taxes can be included in cost of service just as no other hypothetical expenses can be included.[106] Thus, the "actual taxes paid" principle is in reality a particular application of what might be called the "actual costs incurred" principle applicable to all elements of cost on which a rate is based. That there has been extensive litigation focused on the tax element of overall expenses is primarily due to the problems of reconciling the actual costs incurred principle with the congressional purposes embodied in the sections of the Internal Revenue Code discussed above.

When a company's rates are set under individual cost-of-service, then, only actual costs—tax and other—can be included. When area rates are used, however, all elements of cost on which the rate is based are to some degree hypothetical, for they are derived from average costs incurred by producers within the relevant area. Regardless of the category of costs, some producers will actually spend more and some will actually spend less than is attributed to that category in the composition of the area rate. We conclude, therefore, that the tax element of the area rate should not be singled out for special treatment simply because area rates are applied to pipeline production. As with all

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[105] Petitioner does not object, as it probably cannot, to the fact that area rates mean that some pipeline companies will pay more taxes than they are allowed under the area rate.

[106] *See e.g.*, Panhandle Eastern Pipe Line Co. v. FPC, 113 U.S. App. D.C. 94, 97-98, 305 F.2d 763, 766-67 (1962); cases cited note 96, *supra*.

other elements of cost, we believe that the average amount expended by a producer in the area is the appropriate amount for inclusion in the rate.

One further point calls for attention, however. In discussing the tax issue, the Commission stated that

> in the pipeline's rate case [its own] production will be allowed an area rate in which the presence or absence of a tax component will depend upon whether it has been shown that, under the tax laws then in effect, gas production operations of the industry as a whole on the average result in the payment of any Federal income taxes. But regardless of this determination, it is to be expected that some pipelines (like some indepentent producers) will be able to show that they paid taxes on their production activities, while others (also like some independent producers) will have tax credits which can serve to reduce the taxes upon their other operations.[107]

In the *Permian Basin* and *Southern Louisiana* rate cases, the Commission fixed the tax element of the rate at zero. It appears to us, however, that this figure represents only the Commission's determination that the average producer would pay no taxes on income from production activity;[108] it does not represent a determination that the average producer would neither pay taxes nor have a net tax loss which could be used to reduce other tax liability. Thus, a zero tax element in an area rate may in fact be too high.[109]

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[107] 42 F.P.C. at 750-51.

[108] Southern Louisiana Area Rate Proceedings, 40 F.P.C. 530, 581-86 (1968); Permian Basin Area Rate Proceedings, 34 F.P.C. 159, 206-07 (1965).

[109] The Commission's staff has itself raised this possibility. II Joint Appendix 730: "It may be correct that the independent producer area rate is overstated insofar as it does not allow for a negative tax credit or consideration of tax losses generated by the production function in the area rate of return component." The staff, however, would solve this problem by fixing a separate tax component for each pipeline company.

The propriety of the actual amount set for any element of an area rate is not presently before us and we raise the above issue only because petitioner has indicated that use of area rates will result in the absence of savings to the consumer stemming from tax savings "spilled over" from pipeline production activity to transmission activity. In the case of an independent producer, it may well be that the Commission has not considered as within its area of concern the spill-over benefits of a net tax loss on production activity. Such producers may have no other jurisdictional activities in which the spilled over benefits *could* be used, and the Commission may have considered that its function was at end when it concluded simply that consumers should pay nothing for taxes because no tax liability would be incurred. In the case of pipeline production, however, there is another jurisdictional activity in which spilled-over benefits *could* be used, namely pipeline transmission activity. There would thus be some force to an argument that the Commission cannot simply stop when it has determined that pipelines, on the average, will pay no taxes on their production activity but must then go on to determine whether they will have a net tax loss and should reflect that loss by including a negative tax element in the area rate.

The record does not reflect whether the Commission has fully explored the problem outlined immediately above. Ordinarily, under such circumstances, we would remand the case to the Commission so that it could supply this omission. However, we believe that that evaluation would be most appropriately undertaken in the context of an actual area rate proceeding in which the Commission gathers before it all relevant financial data concerning producers in the area. Since resolution of the instant problem requires, in our view, careful

examination of just such data, a remand for further exploration in the context of these proceedings would eventually result in great duplication of effort.

Accordingly we affirm the Commission's decision to include the same tax element in the area rates applicable to independent producers and to pipeline companies with one caveat: If the data compiled in an actual area rate proceeding support the conclusion that the average income tax paid by *all* affected producers in the area under consideration is less than zero, and if it is impossible to include a negative tax element in the area rate applicable to independent producers, our decision does not preclude any proper party from contending that the area rates applicable to independent producers and to pipeline companies should contain different, though not necessarily individualized, tax elements.

With that caveat and our comments concerning the rate of return in mind, we affirm the order of the Federal Power Commission hereunder review.

Judgment accordingly.

APPENDIX A

The *Commission,* acting pursuant to the authority of the Natural Gas Act, as amended, particularly Sections 4, 5, 8 and 16 thereof (52 Stat. 822, 823, 825, 830; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717g, 717o), *orders:*

(A) Effective upon issuance of this statement, Part 2, Subchapter A, General Rules, Chapter 1 of Title 18 of the Code of Federal Regulations, is amended by adding a new Section 2.66 to read as follows:

§ 2.66 *Pricing of New Gas Produced by Pipelines and Pipeline Affiliates.*

(a) As a matter of policy in future pipeline rate proceedings, gas produced by pipelines or by their affiliates

from leases acquired after the date of this order will be priced for rate making purposes at the just and reasonable area rate applicable to gas of a vintage corresponding to the date of completion of the first well on the lease, otherwise at the "in-line" price, or, if there is no in-line price, on the basis of the guideline price set forth in Section 2.56 of our Rules, with the following exceptions:

(1) If a pipeline or pipeline affiliate acquires a developed lease from which jurisdictional sales are being made, the applicable price of gas shall be the lower of (a) the contract price applicable to the gas, or (b) the applicable area price (or in-line or guideline price);

(2) If a pipeline or pipeline affiliate acquires a developed lease from which nonjurisdictional sales are being made, gas produced from the lease will be priced at the just and reasonable area price applicable to gas of the vintage corresponding to the date of lease acquisition (or in-line or guideline price);

(3) If the pipeline is able to show in a rate proceeding that special circumstances exist which justify different treatment, such a showing should be made by means of a special schedule and supporting evidence filed in addition to the material otherwise required by Section 154.63 of the Regulations.

(b) Pipelines acquiring production leases subsequent to the date of this opinion either on their own part or through affiliates should:

(1) Where they have their own production maintain separate subdivisions of their plant and expense accounts related to production properties and production activities, so as to show separately costs related to production from present leases

and costs related to production from leases acquired after the date of this opinion;

(2) In making a rate filing provide additional detail in subdivisions within the production function, *i.e.*, as between gas from present leases and gas from leases acquired after the date of this opinion with respect to their own production and also with respect to any production of their affiliates.

42 F.P.C. 738, 753 (1969).

The *Commission,* acting pursuant to the authority of the Natural Gas Act, as amended, particularly Sections 4, 5, 8 and 16 thereof (52 Stat. 822, 823, 825, 830; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717g, 717o), *orders:*

(A) The applications for rehearing filed by the Municipal Group, California and El Paso are denied.

(B) Effective upon issuance of this statement Section 2.66(a), promulgated by our order of October 7, 1969, Part 2, subchapter A, General Rules, Chapter 1 of Title 18 of the Code of Federal Regulations is amended as follows:

§ 2.66 *Pricing of New Gas Produced by Pipelines and Pipeline Affiliates.*

(a) * * *

(1) If a pipeline or pipeline affiliate acquires a developed lease from which jurisdictional sales are being made and Paragraph (3) below does not apply, the applicable price of gas shall be the lower of (a) the contract price applicable to the gas, or (b) the applicable area price (or in-line or guideline price);

(2) If a pipeline or pipeline affiliate acquires a developed lease from which nonjurisdictional sales

are being made and Paragraph (3) below does not apply, gas produced from the lease will be priced at the just and reasonable area price applicable to gas of the vintage corresponding to the date of lease acquisition (or in-line or guideline price);

(3) If a pipeline or pipeline affiliate acquires a developed or undeveloped lease, either directly or through intermediaries, from another pipeline or affiliate which owned the lease prior to the date of Opinion No. 568, the lease so acquired after the date of Opinion No. 568 shall be subject to cost-of-service treatment for ratemaking purposes, subject to further determinations in Phase II of these proceedings.

(4) If the pipeline is able to show in a rate proceeding that special circumstances exist which justify different treatment, such a showing should be made by means of a special schedule and supporting evidence filed in addition to the material otherwise required by Section 154.63 of the Regulations.

42 F.P.C. 1089, 1093 (1969).

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

September Term, 1971

No. 23,740

CITY OF CHICAGO, ILLINOIS, ET AL., *Petitioners*

v.

FEDERAL POWER COMMISSION, *Respondent*

PIPELINE PRODUCTION GROUP, MID LOUISIANA GAS COMPANY, PENNZOIL PRODUCING COMPANY, TENNESSEE GAS PIPELINE COMPANY, CONSOLIDATED GAS SUPPLY CORPORATION, ET AL., TENNECO OIL COMPANY, *Intervenors*

Petition for Review of an Order of the Federal Power Commission

Before: MACKINNON, ROBB and WILKEY, Circuit Judges.

Judgment

This case came on to be heard on the record from the Federal Power Commission, and was argued by counsel. On consideration thereof, it is

ORDERED AND ADJUDGED by this Court that the order of the Federal Power Commisison on review herein is hereby affirmed.

Per Curiam

For the Court:

/s/ NATHAN J. PAULSON
Nathan J. Paulson
Clerk

Dated: December 2, 1971.

Opinion by Circuit Judge MacKinnon.

APPENDIX B

Opinion No. 568

PIPELINE PRODUCTION AREA RATE PROCEEDING (PHASE I), DOCKET NO. RP66-24

STATEMENT OF POLICY AS TO PRICING OF NEW GAS PRODUCED BY PIPELINES AND PIPELINE AFFILIATES

(Issued October 7, 1969)

* * *

POLICY STATEMENT; AREA RATES; PIPELINES (PRODUCTION); COST OF SERVICE (TAXATION); ACCOUNTING (PIPELINE PRODUCTION); RATE SCHEDULE (FILING); RATES (PIPELINE)

Before Commissioners: John N. Nassikas, Chairman; L. J. O'Connor, Jr., Carl E. Bagge, John A. Carver, Jr. and Albert B. Brooke, Jr.

O'CONNOR, *Commissioner:*

This is an investigation to determine whether in pipeline rate making the Commission should depart from the cost-of-service method and adopt an area method for pricing gas produced by pipelines or acquired by them from their affiliates.

The investigation was initiated by the Commission's order of June 29, 1964, in the *Hugoton-Anadarko* area proceeding, AR64-1, *et al.*, 31 FPC 1595. After certain direct evidence had been submitted, upon Staff's motion the Commission, on April 13, 1966, severed the *Pipeline Production* proceeding, 35 FPC 497, from *Hugoton-Anadarko* saying that the evidence indicated that this area was not typical of the country as a whole. The Commission noted that "whether the Commission may or should depart from the cost-of-service method in fixing the price of pipeline produced gas is the precise issue to be determined in this investigation." It ordered that a separate proceeding be

instituted "to determine the proper method to be used by the Commission in pricing natural gas produced by pipelines or acquired by them from their affiliated producers" and joined a list of pipeline companies as parties-respondent. The Commission required that Phase I, which is now before the Commission comprise:

> What is the most appropriate pricing method to be applied to natural gas utilized in a pipeline's interstate system which is produced by the pipeline or its affiliated producing company from leases acquired after the date of determination of this issue.

By order of May 25, 1966, 35 FPC 806, the Commission joined a group of producer companies that are affiliates of the pipeline respondents and on December 5, 1966, 36 FPC 954, denied a motion by a pipeline production group (Pipeline Group)[1] for an informal rule making proceeding.

After a prehearing conference the hearing began on September 27, 1967, and was concluded on April 2, 1968, and the decision of Presiding Examiner Allen C. Lande was issued March 3, 1969.

Exceptions were filed by the Pipeline Group, El Paso Natural Gas Company, A Municipal Gas Group (Municipal Group), Consolidated Gas Supply Corporation and Public Service Electric and Gas Company (Consolidated and PSEG), Union Producing Company, Tenneco Oil Company, Cities Service Oil Company, Tennessee Gas Pipeline Company (Tennessee), Southern California Gas Company,

[1] Cities Service Gas Company, Humble Gas Transmission Company, Colorado Interstate Gas Company, Kansas-Nebraska Natural Gas Company, Inc., Lone Star Gas Company, Natural Gas Pipeline Company of America, Northern Natural Gas Company, Panhandle Eastern Pipe Line Company, Southern Natural Gas Company, Texas Gas Transmission Corporation, Transcontinental Gas Pipe Line Corp., Trunkline Gas Company, United Fuel Gas Company, and United Gas Pipe Line Company.

Southern Counties Gas Company of California and Pacific Lighting Service Company (Southern California Companies), Pacific Gas and Electric Company (PG&E), a group of Producer Intervenors,[2] Humble Oil & Refining Company and Humble Gas Transmission Company (Humble), The People of the State of California and the Public Utilities Commission of the State of California (California), and the Staff of this Commission. Briefs opposing exceptions were filed by the Pipeline Group, El Paso, the Municipal Group, Consolidated and others (Consolidated Group),[3] Tenneco Oil, Cities Service Oil, Union, California, and our Staff. As the Examiner noted, four general positions have been advanced. The Pipeline Group and certain others have advocated use of the same area rate as for independent producers. El Paso and the Municipal Group have advocated a continuation of the Commission's present cost-of-service policy. Consolidated has advocated cost-of-service rates solely for Appalachia, but unmodified area rates for the other areas. The Staff has advocated area rates but with individual rate of return and Federal income tax components.

The Examiner, generally, would retain the traditional cost-of-service approach. However, he would permit the pipeline producers (known as Group 1) to share the Federal Income Tax benefits 50-50 with consumers. The on-system pipeline affiliates (Group 3) and the off-system pipeline affiliates (Group 4) would be allowed for on-system sales the applicable area rate for 10 percent of their new gas production, but the remainder of their on-system sales volumes would be subject to cost-of-service, without benefit of any tax sharing. New production sold off-system would receive the area or the in-line rate.

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[2] Amerada Petroleum Corporation, Continental Oil Company, Mobil Oil Corporation, Pan American Petroleum Corporation, Shell Oil Company, and Texaco Inc.

[3] Iroquois Gas Corporation, Pennsylvania Gas Company, United Natural Gas Company and Kentucky West Virginia Gas Company.

This is a turning point in the regulation of pipelines owning their own reserves, but it follows closely upon the development of area regulation for the independent producers and a changing picture in the gas supply situation as shown by the record and other facts coming to our attention. In the light of an apparent gas shortage we are concerned whether the pipelines will make an increased effort to explore for and develop new gas reserves. We are also concerned whether new gas supplies will be available to the consumers of gas served by the long pipelines. To attain these ends it may be incumbent upon us to modify traditional approaches to regulation with respect to pipeline production in order to provide a regulatory climate conducive to an aggressive pipeline exploration program.

For many years the Commission has determined the cost of pipeline-owned production facilities, like the other components of a pipeline's jurisdictional operations, on an individual company cost-of-service basis. See, *e.g.*, *Canadian River Gas Co., et al.*, 3 FPC 32 (1942), affirmed *sub nom.*, *Colorado Interstate Gas Co.* v. *F.P.C.*, 142 F.2d 943 (CA10-1944), affirmed, 324 U.S. 581 (1945); *Cities Service Gas Co.*, 3 FPC 459 (1943); affirmed, 155 F.2d 694 (CA10-1946), certiorari denied, 329 U.S. 773 (1946); *City of Cleveland* v. *Hope Natural Gas Co.*, 3 FPC 150 (1942), affirmed *sub nom.*, *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944); *Panhandle Eastern Pipe Line Co.* v. *F.P.C.*, 324 U.S. 635 (1945). However, we have turned to an area pricing approach with respect to the just and reasonable price at which independent producers—who on a national basis provided 86.41 percent of the gas entering into the lines of the respondent interstate pipelines in 1962, and as of that year owned an estimated 82.36 percent of total reserves owned by or dedicated to the respondent pipelines—may sell gas to the interstate pipelines. The issue in Phase I of this proceeding is whether we should now apply such area rates, or some variant or modification thereof, in future pipeline rate cases to value the gas produced from pipeline owned (or pipeline

affiliate owned) leases acquired after the date of this decision and taken into the pipeline's own system.

For the reasons set forth, we conclude that, subject to a showing in such future pipeline rate cases of special circumstances warranting a different result, the just and reasonable area rate ceilings governing sales by independent producers to the various pipelines (or, where area just and reasonable rates have not yet been set, the appropriate in-line or guideline price applicable to sales by independent producers) should be utilized for such purposes.

It is important at the outset to define the limitations of this decision. We are not primarily concerned in this proceeding with pipeline production sold off system to other pipelines. We think that the applicable area rate should apply to such production. Furthermore, we have previously held in *Union Producing Company*, 31 FPC 41, that gas sold off-system by affiliates should be treated like production from independent producers, and there is no reason to disturb this conclusion here. Nor are we concerned here with gas taken into a pipeline's system—past, present, or future—from production facilities on leases acquired prior to the date of the decision herein. The question of whether we should prospectively depart from pricing such gas on an individual company cost-of-service basis is to be considered in Phase II of this proceeding. That issue involves separate problems relating to the historical context under which such production efforts were undertaken which by no means necessarily call for the same resolution to be given to future production from leases acquired after, and in the light of, this decision.

The legality of the existing system of valuing pipeline production utilized in the pipeline's operations by no means attests to its rationality with respect to future acquired leases. Most, if not all, of the basic incongruities presented in attempting to fix the cost of an independent producer's production on an individual company, historical, cost-of-

service basis, to which we referred in the second Phillips case,[4] and in the *Permian* area rate case,[5] are equally applicable in the case of a pipeline's own production. In fact, they were originally noted by Justice Jackson in opinions relating to the costing of a pipeline's own production, issued prior to the time when it was recognized that this Commission had any responsibility for fixing the rates at which independent producers sold gas in interstate commerce.[6]

These logical anomalies in continuing to price pipeline-owned production on an individual company cost-of-service basis are clearly enhanced, once the maximum sales prices by independent producers (who are, and at least in the foreseeable future will continue to be, the primary source of natural gas) are set on an area basis. Thus, if a pipeline can purchase gas from independent producers in a given field at an area price fixed by the Commission, a most serious question is presented as to whether it would be in the public interest (and not unduly discriminatory) to permit a pipeline to charge its customers a substantially higher price for gas it produced itself from the same field merely because its overall costs of production for a particular test period turned out to be higher than the area rate. Conversely, if as many of pipeline participants in this proceeding urge is the case, pipelines can successfully conduct production operations at the area rate fixed for independent producers, there is no reason why their consumers should be deprived of the benefit of such enhanced partici-

[4] *Phillips Petroleum Co.*, 24 FPC 537, 542-548 (1961), affirmed, 373 U.S. 294 (1963).

[5] *Permian Area Rate Proceeding*, Docket No. AR61-1, 34 FPC 159, 178-179, affirmed *Permian Basin Area Rates Cases*, 390 U.S. 747 (1968).

[6] See *F.P.C. v. Hope Natural Gas Co.*, 320 U.S. 591 at 649 (1944) (dissenting opinion); *Colorado Interstate Gas Co. v. F.P.C.*, 324 U.S. 581 at 610 (1945) (concurring opinion).

pation in the production area by industry elements specially concerned with the maintenance of an adequate gas supply, merely because some of the pipelines—or even a majority of them—can conduct such operations at a more profitable rate of return than we might allow the pipeline as a whole to earn on an individual cost-of-service basis.[7]

Cost-of-service pricing of pipeline production, except with respect to some old production facilities acquired at very low cost before the development of the natural gas industry as we know it, has lead in the main to high-cost gas coupled with a continuing reduction in the relative amount of pipeline production. If pipelines, by moving to an area rate technique, can be encouraged to increase their activity in the search for and production of gas without increasing the overall cost of the gas to the consuming public, this certainly should be encouraged. And assuming, *arguendo*, the continuing applicability of the dictum of *City of Detroit* v. *F.P.C.*, 230 F. 2d 810 (CADC-1955), certiorari denied 352 U.S. 829 (1956), clearly the "anchor" the court there felt should be the "point of departure" in moving to a pricing system other than the conventional rate-base method (*ibid.* at 818-819) lies in the approved just and reasonable area rates for independent producers.

We arrive at this conclusion at a time when there are indications of a shortage of gas and a threat of a greater shortage in the future. For instance, for the first time the American Gas Association reported that in 1968 net gas production exceeded the reserves added resulting in a decline in total proved reserves from 292.9 trillion cubic feet to 287.3 trillion cubic feet by the end of 1968.[8]

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[7] We note that we lack authority to preclude pipelines from choosing to enter areas of operation considerably more risky and less related to pipeline operations than gas production, and that if we were to preclude the successful pipeline producer from reaping the rewards which may be available at area rates, the alternative is not likely to be greater production activity at lower yields.

[8] AGA Committee on Annual Gas Reserves; Report issued April 7, 1969.

While the 1968 figures are not in the record, the present trend is reflected by the record. Preeminent are the reserve-production ratios showing the ratio of reserves to production during the year. This ratio, for the United States, with some slight ups and down, has trended generally downward from 22.1 in 1955 to 14.8 in 1968. Of course, the reserves owned by pipeline producers are only a portion of the whole but pipeline production has not been progressing satisfactorily. In fact, the owned reserves of pipeline producers have declined 29.9 percent between 1958 and 1966, and, as a percentage of total reserves, have declined from 25 percent in 1958 to 13 percent in 1966. In spite of this trend, as argued by the Pipeline Production Group and other parties, the pipeline producers are capable of making a significant contribution to new gas supplies.

It is contended that the area price concept cannot legally be made applicable to the production operations of pipelines since the record evidence of their historical costs of operation shows a considerably greater spread from the mean average than in the case of independent producers. This evidence, however, merely reflects the wide divergencies in the periods of time and surrounding circumstances in which the pipelines presently with production originally undertook such operations, and by no means indicates that their costs for production from future acquired leases are likely to diverge significantly over a period of time, either from one another or from the average experience of independent producers on similar lease vintages.[9] Similarly,

[9] Particular pipelines, of course, could experience higher than average costs if, for example, they made a practice of purchasing more developed and hence more expensive leases. While there could be circumstances where more costly operations were required by public convenience and necessity (such as arguably was the case when El Paso, then largely dependent upon casinghead gas subject to the vagaries of oil production regulation, purchased developed acreage in the San Juan Basin), the area rate pricing technique quite appropriately places the burden for demonstrating the special circumstances for imposing the extra cost of such opera-

the argument that the cost evidence from the all-areas questionnaire demonstrates that the pipelines as a group had per Mcf costs significantly higher than those of the independent producers, does not demonstrate the invalidity of utilizing the area rates already fixed, or to be fixed, for future vintages of gas produced by independent producers; not only is the issue here limited to future gas vintages with respect to which such historical experience is not the measure for fixing just and reasonable rates, but the techniques applied in both the *Permian* and *Southern Louisiana* area rate cases to fix the area rate ceilings for future vintages of gas depended, in large part, upon industry-wide statistics which included the current production experience of the pipelines.

Equally unpersuasive are the contentions made by the Commission's staff, endorsed by the California Commission, that, while an area rate should be applied to pipeline production, the price to be permitted independent producers for gas from new leases should be significantly reduced for pipelines by substituting individual pipeline costs or allowances for various components of the area rates as

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tions upon the pipeline. The present cost-of-service methology, on the contrary, tends to put a premium upon high-cost operations (and upon indifference to cost considerations), in view of the extreme difficulty of the agency meeting the standard required to disallow expenditures as improvident.

In this same context is the use by pipelines of their reserves as a flexible source of gas supply; in other words they are said to "swing" on its reserves. Its independence in this respect and others is one of the advantages of a pipeline owning its reserves, and the advantage to the pipeline may offset any financial detriments incurred. On the other hand it may be more advantageous for a pipeline to purchase its gas supplies from independent producers. Under normal conditions, we can leave these matters to the judgment of the pipelines, and, if pipeline production is subject to area rates rather than individual cost-of-service, the consumer will be protected against expensive modes of operation where there is no corresponding cost saving.

determined in *Permian* and *Southern Louisiana*. Primarily the staff would allow only the lower over-all rates of return fixed for the individual pipelines instead of the 12 percent rate specified for independent producers in both the *Permian* and *Southern Louisiana* cases, and would utilize the individual pipeline plant liquid credit figures. We are not persuaded that the financing of pipeline production operations are in fact markedly cheaper than the financing of such efforts by independent producers, or that pipelines can significantly utilize their debt resources to reduce the cost of production activities. Moreover, we think the argument of the Pipeline Production Group that the staff has chosen for special treatment the facets of production operations which might tend to be cheaper for pipelines, while using the general industry-wide figures in those areas where pipeline production costs might be expected to be above average, has considerable merit.

The principal objection to the staff position, however, lies in its basic assumption that if, as the staff apparently believes, average pipeline production costs for future developed leases will or should be cheaper than the costs of independent producers, the differential should accrue to the pipeline's ratepayers rather than to the pipeline. This is virtually guaranteed to discourage pipelines from entering the production area to any large degree. It is, moreover, basically inconsistent with a major premise of area pricing, that low-cost producers should reap the reward of their luck or efficiency. There is certainly no less reason why this should be true for pipelines than for independent producers. On the contrary, since the pipelines can be expected to have a greater incentive to explore for and develop gas reserves than the independent producers, the assurance that they will be rewarded if, despite the risks of any production operation, they can produce gas at less than average cost can only benefit the consuming public. At the same time the public is protected by the area rate concept from bear-

ing the brunt of the unsuccessful or otherwise unnecessarily high-cost pipeline production efforts.

Consolidated, while supporting the area rate concept for pipeline production generally, argues that for Appalachia pipeline production should continue to be regulated on an individual company cost-of-service basis. The atypical nature of Appalachian production as a matter of history, cost, relative importance of pipeline production activities, production per well and value of the gas in view of its location factor are among the reasons advanced for separate treatment. To a large extent it would appear that these arguments (which to a varying extent are also applicable to some of the other production areas outside of the major production regions in which area rate proceedings have already been held or are in progress) are primarily directed to the question of what the particular area rate level should be, rather than whether individual company cost-of-service pricing should be maintained for pipeline production on future acquired leases.[10] Thus Consolidated's arguments make clear the inappropriateness of any individual company cost-of-service pricing for the many small independent producers in Appalachia. At the same time serious questions could be raised as to the propriety of any system which would fix an area rate for independent producers which would permit them to secure less for comparable production operations than the pipelines could secure on a cost-of-service basis, or the feasibility of a system under which area independent producers would be allowed to secure different rates for their gas depending upon the differing production costs of the pipelines they sold to (with still different prices where the pipeline purchasers are not themselves producers).

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[10] Gas from such leases taken into pipeline's system is most unlikely to be involved in pipeline rate cases in any significant amount, prior to the establishment of area just and reasonable prices.

We do not, however, attempt any conclusive determination of this question here. Our general policy, in the case where pipeline production taken into its system from newly acquired leases originates in areas where there is no just and reasonable area rate, will be to allow the appropriate in-line, or guideline, price applicable to independent producers in such area,[11] but we shall provide all pipelines an opportunity in such rate cases (analogous to the petitions for special relief available to independent producers) to show that the public interest requires special treatment for their own production.

An issue has been raised in this proceeding as to the treatment in any pipeline rate case of any Federal income tax credits which may be available to the particular pipeline as a result of its production activities on newly-acquired leases. Of course, in the pipeline's rate case such production will be allowed an area rate in which the presence or absence of a tax component will depend upon whether it has been shown that, under the tax laws then in effect, gas production operations of the industry as a whole on the average result in the payment of any Federal income taxes. But regardless of this determination, it is to be expected that some pipelines (like some independent producers) will be able to show that they paid taxes on their production activities, while others (also like some independent producers) will have tax credits which can serve to reduce the taxes upon their other operations.

The staff contends that any tax credits which accrue to an individual pipeline should be deducted from the tax

[11] In the case of San Juan the 13-cent per Mcf new gas rate may well be too low under governing cost and value conditions to serve as an inducement price, and we will be prepared to consider its modification. However, in the absence of a showing not approached on this record, we see no basis for establishing a differential system under which pipelines would receive a substantially greater price for production from newly-acquired leases than independent producers.

allowance for its pipeline transmission operations. (Presumably, under this view, where a particular pipeline could show its production activities from newly-acquired leases incurred federal taxes, they would be added to the allowance for the pipeline's transmission operations; otherwise, the inequity of the staff proposal would be apparent.) The Pipeline Production Group, on the other hand, claims that to be put on a par with independent producers, who, to the extent market forces permit, can utilize tax savings as they see fit, the pipeline producers should be entitled to the benefit of the tax credits by not having them considered in fixing the tax allowance on their transmission operations.

Under circumstances where the pipeline's production activities, like the rest of its system, are valued for rate making purposes on a conventional individual company cost-of-service basis, it has been held that tax credits from production operations must be utilized to reduce the taxes paid on the total jurisdictional operation, thereby decreasing the pipeline's overall cost of service, and should not be used as an inducement for pipelines to participate in the production of natural gas. Under individual company cost-of-service pricing of production facilities this inducement is the function of the Commission's rate of return determination, and, if a higher return is appropriate for the production side of the pipeline's activities, this must be justified as such rather than through treatment of the production tax benefits. *El Paso Natural Gas Co. v. F.P.C.*, 281 F. 2d 567 (CA5-1960), certiorari denied 366 U.S. 912 (1961).

We do not believe that the holding of this case is applicable to the situation presented here, where the pipeline's production activities are being valued on the area rate basis applicable to independent producers, who have the option to reinvest the advantages of any tax credits they may incur as a result of their gas-production activities into further gas exploration and development. If, as we hold, pipelines engaged in production activities are to be treated

in the future, on newly acquired leaseholds, as though they were independent producers, and afforded a per Mcf price for gas taken into their systems totally unrelated to their particular costs, particular rate of return considerations, or particular tax situation, then we believe they should be placed on a par in all respects. This should include the availability to the individual pipeline as a result of its production activities of any tax credits or its incurrence of any tax liability.

It is possible that some pipelines, like some independent producers, will choose not to utilize any tax credits they happen to accrue from their gas production activities to advance their production activities. But this is no more a basis for establishing a pricing system which puts pipelines, as a class, at a disadvantage than would be the case if we were to hold that pipelines as a class should be on area rates with respect to their production activities, while low-cost pipelines should be required to flow through some or all of their cost savings to their rate-payers. Essentially, the staff's position on production tax credits is that pipeline production should be priced upon the basis of an area rate maximum price, discounted by savings relevant to an individual company cost-of-service approach. As we have stated earlier the end result of such a pricing system would tend to discourage the pipelines from entering into or increasing their current rate in the production field.

Pipeline producers are henceforth to be treated on a parity with independent producers. By so doing we are encouraging intensified exploration by the pipeline producers. We would anticipate that gas produced from leases acquired after the issuance of this opinion would be promptly dedicated in the public interest to assure the adequacy of the supply of natural gas.

In accordance with the above discussion we shall require that pipeline producers generally price the new lease gas produced by or delivered to them by their affiliated pro-

ducers at the area rate applicable to gas under contracts of a vintage corresponding to the date of completion of the first well on the lease. Consistent with our decision in Opinion No. 567 (*Area Rate Proceeding*, Docket No. AR64-1, *supra*, p. 726, issued October 3, 1969), the area rate applicable to production from any gas reservoirs discovered on such leases after the date of completion of the first well shall be controlled by the discovery date. However, where the pipeline or its affiliate acquires developed leases from which jurisdictional sales are being made the applicable price shall be the lower of the contract price or the applicable area price, so that the acquisition of gas reserves by the pipeline does not result in an increase in price. Where the pipeline or its affiliate acquires a developed lease from which nonjurisdictional sales are being made, the gas will be priced at the area price applicable at the date of lease acquisition. In any case where there is no area rate we shall require that they employ the in-line price determined by us or, failing that, the guideline price. We are also providing for exceptions from the area rate upon a proper showing of special circumstances in a pipeline rate filing.

Pipelines should keep their records on a basis which will enable them and the Commission to achieve the necessary division of costs. We have instructed our Staff to examine the need for amendments to our Uniform System of Accounts and rules governing pipeline rate filings.

A question has been raised by the Pipeline Group as to the effective date of these proceedings. As the Examiner points out, Phase I of the proceedings, as defined in our order of April 13, 1966 (35 FPC at p. 499), is to apply to gas produced from leases acquired after the determination of this issue. The Pipeline Group argues that the cut-off date should be January 1, 1961, used in *Permian* and *Southern Louisiana*, saying that the industry was informed by then as to the possibility of area rates being applied to pipeline production. We provided that Phase I apply

only to after-acquired leases in order to expedite the proceedings and to avoid complications and evidentiary problems. The Phase I proceedings were conducted on this basis. To change the basis now would introduce issues that were not previously involved and should not be permitted.

Union has excepted to the Examiner's denial of its motion to be discharged from this proceeding on the ground that it is an independent producer and should be treated as such. It was made a party respondent by our order of May 25, 1966, 35 FPC 806. As an affiliate of United Gas Pipe Line Company, selling gas to that company it is properly a respondent in these proceedings and its exception should be denied although it appears to have obtained its substantive objectives.

A group entitled the "United Distribution Companies" on July 16, 1969 filed a petition for leave to intervene and to file a statement of position. Answers opposing the petition were filed by El Paso, the Municipal Group and our staff. Because the petitions are not timely, a number of members of the group are already represented in these proceedings, and the assertions made by the group of a gas shortage do not add any new element to our general knowledge of the industry or the record in these proceedings, we shall deny the petition.

The Commission further finds:

(1) The notice and effective date provisions of Section 4 of the Administrative Procedure Act, 5 U.S.C. 553, do not apply with respect to the amendment here adopted.

(2) It is appropriate and in the public interest in administering the Natural Gas Act to promulgate Commission policy on pricing natural gas produced by pipelines and their affiliates from leases acquired after the date of this order.

The *Commission*, acting pursuant to the authority of the Natural Gas Act, as amended, particularly Sections 4, 5, 8 and 16 thereof. (52 Stat. 822, 823, 825, 830; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717g, 717o), *orders:*

(A) Effective upon issuance of this statement, Part 2, Subchapter A, General Rules, Chapter 1 of Title 18 of the Code of Federal Regulations, is amended by adding a new Section 2.66 to read as follows:

§ 2.66 *Pricing of New Gas Produced by Pipelines and Pipeline Affiliates.*

(a) As a matter of policy in future pipeline rate proceedings, gas produced by pipelines or by their affiliates from leases acquired after the date of this order will be priced for rate making purposes at the just and reasonable area rate applicable to gas of a vintage corresponding to the date of completion of the first well on the lease, otherwise at the "in-line" price, or, if there is no in-line price, on the basis of the guideline price set forth in Section 2.56 of our Rules, with the following exceptions:

(1) If a pipeline or pipeline affiliate acquires a developed lease from which jurisdictional sales are being made, the applicable price of gas shall be the lower of (a) the contract price applicable to the gas, or (b) the applicable area price (or in-line or guideline price);

(2) If a pipeline or pipeline affiliate acquires a developed lease from which nonjurisdictional sales are being made, gas produced from the lease will be priced at the just and reasonable area price applicable to gas of the vintage corresponding to the date of lease acquisition (or in-line or guideline price);

(3) If the pipeline is able to show in a rate proceeding that special circumstances exist which justify

different treatment; such a showing should be made by means of a special schedule and supporting evidence filed in addition to the material otherwise required by Section 154.63 of the Regulations.

(b) Pipelines acquiring production leases subsequent to the date of this opinion either on their own part or through affiliates should:

(1) Where they have their own production maintain separate subdivisions of their plant and expense accounts related to production properties and production activities, so as to show separately costs related to production from present leases and costs related to production from leases acquired after the date of this opinion;

(2) In making a rate filing provide additional detail in subdivisions within the production function, *i.e.*, as between gas from present leases and gas from leases acquired after the date of this opinion with respect to their own production and also with respect to any production of their affiliates.

(B) The Secretary shall cause prompt publication of the findings and ordering paragraphs, together with notice of the availability of this entire Opinion, to be made in the Federal Register.

(C) Union Producing's request to be discharged from these proceedings is denied.

(D) The petition filed July 16, 1969, by the United Distribution Companies for leave to intervene and file statement of position is denied.

(E) Except as herein granted, the exceptions to the initial decision are denied.

APPENDIX C

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

OPINION No. 568-A

Docket No. RP66-24

PIPELINE PRODUCTION AREA RATE PROCEEDING
(PHASE I)

Opinion and Order Denying Rehearing

Issued: December 5, 1969

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

POLICY STATEMENT; AREA RATES; PIPELINES (Production); RATES (Pipeline)

Before Commissioners:

John N. Nassikas, Chairman;
Lawrence J. O'Connor, Jr.,
Carl E. Bagge,
John A. Carver, Jr., and
Albert B. Brooke, Jr.

Docket No. RP66-24

PIPELINE PRODUCTION AREA RATE PROCEEDING,
(PHASE I)

O'CONNOR, Commissioner:

1. Applications for rehearing in the above-entitled proceeding were filed on November 6, 1969, by the Municipal Gas Group,[1] by the people of the State of California and the

[1] Consisting of the American Public Gas Association, the City of Chicago, the City and County of Denver, and the Memphis Light, Gas and Water Division.

Public Utilities Commission of California, and by the El Paso Natural Gas Company. In Opinion No. 568 and Order, issued October 7, 1969, the Commission provided by rule that in future pipeline rate proceedings gas produced by pipelines or by their affiliates from leases acquired after the date of the order would be priced for ratemaking purposes at the area rate, in-line price or guideline price applicable with certain exceptions as to the acquisition of developed leases and to the showing of special circumstances. Pipelines were also required to use separate accounting and to show additional detail in rate filings with respect to their present leases and leases acquired after the date of the Opinion.

2. On many of the points made by the applicants on rehearing we think that further discussion, in addition to that found in the original Opinion, would be redundant, but in other respects, further discussion or modification of our original determination is in order.

3. The Municipal Group initially argues that the Commission improperly now seeks to treat the proceedings in this case as in the nature of rulemaking rather than an adjudication controlled by the record hearing provisions of the Administrative Procedure Act, citing 5 U.S.C. § 554 relating to adjudications. However this proceeding may be termed, this was not our intention. We rejected a petition that informal rulemaking procedures by utilized for resolving the Phase I issues (36 FPC 954, 955). We intended to reach our conclusions upon the basis of the record and of such matters as we could take notice as an expert body. in any case, no question can be raised that all parties have not had full notice of the nature of these proceedings and full opportunity to present evidence. The issues were set forth in our order enlarging the issues in the *Hugoton-Anadarko Area Proceeding* (31 FPC 1595, June 29, 1964) and were more fully defined in our order severing these issues (35 FPC 497, April 13, 1966).

4. In connection with our consideration of the record the Municipal Group objects to our finding that the owned reserves of pipeline producers have declined 29.9 percent between 1958 and 1966, and, as a percentage of total reserves, have declined from 25 percent [2] in 1958 to 13 percent in 1966. While the statement was founded on evidence presented by the Pipeline Production Group, it is subject to criticism that it is affected by a substantial write-down of El Paso's reserves (including those of the Pacific Northwest Pipeline Company), the exclusion of the lease-sale reserves at Ship Shoals, Bastian Bay and Rayne Field and the transfer of pipeline reserves to their affiliates. Nevertheless the staff's evidence shows that reserves owned by pipelines and their affiliates attached to their systems have not kept pace in recent years with total reserves in the forty-eight contiguous states, and we think this is very significant from the standpoint of our conclusion here.[3]

5. The Municipal Group argues further that the use of area rates with an exception where the pipeline is able "to show in a rate proceeding that special circumstances exist which would justify different treatment" amounts to permitting cost-of-service or area rates, whichever is higher. That was not our intention. Similar to *Permian* [4] we need not and cannot here specify all of the special circumstances

[2] This was later corrected by the witness to 22 percent. The comparison made was between total pipeline reserves and the pipeline owned reserves.

[3] The staff evidence which tabulates substantially all of the on-system reserves of respondent pipelines and their affiliates amounted in millions of cubic feet to 26,004,457 in 1958, 28,396,480 in 1960 and 25,557,385 in 1965. These figures amount to 10.3 percent, 10.8 percent and 8.98 percent of gas reserves in the forty-eight contiguous states as computed by the American Gas Association Committee on Natural Gas Reserves presented in the record by the Pipeline Production Group, and adjusted to exclude Alaskan reserves.

[4] *Area Rate Proceeding*, 34 FPC 158, 226 (1965).

which may serve as a basis for exceptions to the area rate, but the right to make a showing in no way implies that an exception will be granted merely because the pipeline cannot recover its expenses and earn the return specified for the production rate base.

6. The Municipal Group argues that there is no proof that pipelines will engage in any extra production if given additional profits beyond the present return on equity determined by the Commission. While we cannot find with certainty that area rate costing of pipeline production will cause greater production, we expect that such a pre-determined cost allowance for pipeline producers will induce exploration and development because of the assurance to pipelines that they will stand to gain as a result of superior judgment and efficiency and that any additional gains would not automatically be withdrawn to satisfy a cost formula. Moreover, since the order only applies to production from future acquired leases, "additional" returns, if any, would be earned only to the extent that pipelines were in fact stimulated to explore for and develop new reserves.

7. Finally, the Municipal Group argues that our use of the term "new lease gas" (Par. 27) is ambiguous and that the term should be clarified to ensure the application of area rates only to gas produced from new leases acquired and developed subsequent to our Opinion. The Municipal Group is concerned that old leases could be traded among the pipelines to make them new and therefore eligible for area rates.

8. In our opinion the suggested clarification is not apt. Pipelines intending to develop leases might still be able to trade them before development in order artificially to procure benefits from area pricing. In other cases the requirement of development after the date of our Opinion might prevent the use of area rates without justification. However, we did not intend Opinion 568 to apply to leases acquired, either directly or through intermediaries, from other pipelines or their affiliates which had held them prior

to the date of our opinion. The ratemaking treatment for such leases is to be considered in the remaining phase of this proceeding. However, for the present, we will provide that such leases acquired after the date of Opinion 568 shall be subject to conventional cost-of-service treatment for ratemaking purposes.

9. While El Paso has made extensive arguments in its application for rehearing, these are largely repetitious of previous arguments and have been covered by the discussion in our original Opinion. El Paso argues, however, that our Opinion does not hold that the Examiner's numerous findings on the wide variations in pipeline production costs are incorrect, nor do we make contrary or contradictory findings which would support our conclusion that pipeline producers' costs for production from future acquired leases are likely to be similar to costs of independent producers.

10. The Examiner's initial decision contains many findings of fact that are properly founded on the record. We differ with him, however, as to the conclusions that should be drawn. Since our approach is patently different as shown in our original Opinion, there is no reason to make determinations as to his specific findings, but we shall adopt his decision to the extent it is not inconsistent with our opinions.

11. As to our conclusion on divergent costs of pipeline producers we found (Par. 16) that the evidence "by no means indicates that their costs for production from future acquired leases are likely to diverge significantly over a period of time.". We know of no reason, on the basis of a knowledge of the industry, why pipelines should not be able, regardless of their past methods and policies, to produce gas at as low a cost as the independent producers. For example, evidence presented by the Pipeline Production Group indicates that in the past pipeline producers, affiliated producers and independent producers have been equally successful within narrow limits in exploratory and

developmental drilling, and pipeline drilling costs for productive gas wells have been lower than for the other categories. The staff shows the exploration and development expense and cash production expense ratios have been similar for producing pipelines and for other producers.[5]

The Commissioner further finds:

(1) The assignments of error and grounds for rehearing set forth in the above applications for rehearing present no facts or legal principles which would warrant any change in or modification of Opinion No. 568 and order of October 7, 1969, except as specified below.

(2) The notice and effective date provisions of Section 4 of the Administrative Procedure Act, 5 U.S.C. 553, do not apply with any respect to the amendment here adopted.

The *Commission*, acting pursuant to the authority of the Natural Gas Act, as amended, particularly Sections 4, 5, 8 and 16 thereof (52 Stat. 822, 823, 825, 830; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717g, 717o), *orders:*

(A) The application for rehearing filed by the Municipal Group, California and El Paso are denied.

(B) Effective upon issuance of this statement Section 2.66(a), promulgated by our order of October 7, 1969, Part 2, subchapter A, General Rules, Chapter 1 of Title 18 of the Code of Federal Regulations is amended as follows:

§ 2.66 *Pricing of New Gas Produced by Pipelinesand Pipeline Affiliates*

(a) * * * *

(1) If a pipeline or pipeline affiliate acquires a developed lease from which jurisdictional sales are being made and

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[5] Exhibit 5, Sch. 4, sh. 1 and 2; Sch. 6, col. d. The production operating expense has been higher but this is accounted for by higher depletion, depreciation and amortization expense due to the high-cost leases acquired by some companies. This does not indicate inherent operating differences.

Paragraph (3) below does not apply, the applicable price of gas shall be the lower of (a) the contract price applicable to the gas, or (b) the applicable area price (or in-line or guideline price);

(2) If a pipeline or pipeline affiliate acquires a developed lease from which nonjurisdictional sales are being made and Paragraph (3) below does not apply, gas produced from the lease will be priced at the just and reasonable area price applicable to gas of the vintage corresponding to the date of lease acquisition, (or in-line or guideline price);

(3) If a pipeline or pipeline affiliate acquires a developed or undeveloped lease, either directly or through intermediaries, from another pipeline or affiliate which owned the lease prior to the date of Opinion No. 568, the lease so acquired after the date of Opinion No. 568 shall be subject to cost-of-service treatment for ratemaking purposes, subject to further determinations in Phase II of these proceedings.

(4) If the pipeline is able to show in a rate proceeding that special circumstances exist which justify different treatment, such a showing should be made by means of a special schedule and supporting evidence filed in addition to the material otherwise required by Section 154.63 of the Regulations.

* * * * *

(Sections 4, 5, 8 and 16; 52 Stat. 822, 823, 825, 830; 76 Stat. 72; 15 U.S.C. 717c, 717d, 717g, 717o)

(C) The Secretary shall cause prompt publication of the findings and ordering paragraph, together with notice of the availability of this entire Opinion, to be made in the Federal Register.

(D) The Examiner's opinion to the extent not inconsistent herewith is adopted as a part of our Opinions Nos. 568 and 568-A in this proceeding.

By the Commission.

GORDON M. GRANT,
Secretary.

APPENDIX D

Sec. 1(a) As disclosed in reports of the Federal Trade Commission made pursuant to S. Res. 83 (Seventieth Congress, first session) and other reports made pursuant to the authority of Congress; it is declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

(b) The provisions of this chapter shall apply to the transportation of natural gas in interstate commerce, to the sale in interstate commerce of natural gas for resale for ultimate public consumption for domestic, commercial, industrial, or any other use, and to natural gas companies engaged in such transportation or sale, but shall not apply to any other transportation or sale of natural gas or to the local distribution of natural gas or to the facilities used for such distribution or to the production or gathering of natural gas.

* * * * * * * * * *

Sec. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

(b) No natural-gas company shall, with respect to any transportation or sale of natural gas subject to the jurisdiction of the Commission, (1) make or grant any undue preference or advantage to any person or subject any person to any undue prejudice or disadvantage, or (2) maintain any unreasonable difference in rates, charges, service, facilities, or in any other respect, either as between localities or as between classes of service.

(c) Under such rules and regulations as the Commission may prescribe, every natural-gas company shall file with the Commission, within such time (not less than sixty days from the date this act takes effect) and in such form as the Commission may designate, and shall keep open in convenient form and place for public inspection, schedules showing all rates and charges for any transportation or sale subject to the jurisdiction of the Commission, and the classifications, practices, and regulations affecting such rates and charges, together with all contracts which in any manner affect or relate to such rates, charges, classifications, and services.

(d) Unless the Commission otherwise orders, no change shall be made by any natural-gas company in any such rate, charge, classification, or service, or in any rule, regulations, or contract relating thereto, except after thirty days' notice to the Commission and to the public. Such notice shall be given by filing with the Commission and keeping open for public inspection new schedules stating plainly the change or changes to be made in the schedule or schedules then in force and the time when the change or changes will go into effect. The Commission, for good cause shown, may allow changes to take effect without requiring the thirty days' notice herein provided for by an order specifying the changes so to be made and the time when they shall take effect and the manner in which they shall be filed and published.

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon

filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charges, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect; and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect, the Commision may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible.

Sec. 5. (a) Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification de-

manded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulations, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order: *Provided, however,* That the Commission shall have no power to order any increase in any rate contained in the currently effective schedule of such natural-gas company on file with the Commission, unless such increase is in accordance with a new schedule filed by such natural gas company; but the Commission may order a decrease where existing rates are unjust, unduly discriminatory, preferential, otherwise unlawful, or are not the lowest reasonable rates.

Sec. 16. The Commission shall have power to perform any and all acts, and to prescribe, issue, make, amend, and rescind such orders, rules and regulations as it may find necessary or appropriate to carry out the provisions of this act. Among other things, such rules and regulations may define accounting, technical, and trade terms used in this act; and may prescribe the form or forms of all statements, declarations, applications, and reports to be filed with the Commission, the information which they shall contain, and the time within which they shall be filed. Unless a different date is specified therein, rules and regulations of the Commission shall be effective thirty days after publication in the manner which the Commission shall prescribe. Orders of the Commission shall be effective on the date and in the manner which the Commission shall prescribe. For the purposes of its rules and regulations, the Commission may classify persons and matters within its jurisdiction and prescribe different requirements for different classes of persons

or matters. All rules and regulations of the Commission shall be filed with its secretary and shall be kept open in convenient form for public inspection and examination during reasonable business hours.

Sec. 19(b) Any party to a proceeding under this act aggrieved by an order issued by the Commission in such proceeding may obtain a review of such order in the circuit court of appeals of the United States for any circuit wherein the natural-gas company to which the order relates is located or has its principal place of business, or in the United States Court of Appeals for the District of Columbia, by filing in such court, within sixty days after the order of the Commission upon the application for rehearing, a written petition praying that the order of the Commission be modified or set aside in whole or in part. A copy of such petition shall forthwith be transmitted by the clerk of the court to any member of the Commission and thereupon the Commission shall file with the court the record upon which the order complained of was entered, as provided in section 2112 of title 28, United States Code. Upon the filing of such petition such court shall have jurisdiction, which upon the filing of the record with it shall be exclusive, to affirm, modify, or set aside such order in whole or in part. No objection to the order of the Commission shall be considered by the court unless such objection shall have been urged before the Commission in the application for rehearing unless there is reasonable ground for failure so to do. The finding of the Commission as to the facts, if supported by substantial evidence, shall be conclusive. If any party shall apply to the court for leave to adduce additional evidence, and shall show to the satisfaction of the court that such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence in the proceedings before the Commission, the court may order such additional evidence to be taken before the Commission and to be adduced upon the hearing in such

manner and upon such terms and conditions as to the court may seem proper. The Commission may modify its findings as to the facts by reason of the additional evidence so taken, and it shall file with the court such modified or new findings, which if supported by substantial evidence, shall be conclusive, and its recommendation, if any, for the modification or setting aside of the original order. The judgment and decree of the court, affirming, modifying, or setting aside, in whole or in part, any such order of the Commission, shall be final, subject to review by the Supreme Court of the United States upon certiorari or certification as provided in [former] sections 239 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 1254).